2010

AICPA audit committee toolkit : Not-for-profit organizations

American Institute of Certified Public Accountants. Audit Committee Effectiveness Center

CNA Financial Corporation

Audit Committee Effectiveness Center

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The primary mission of the AICPA's Audit Committee Effectiveness Center is to improve audit committee performance to the benefit of an organization's many stakeholders. The array of current and future resources available through this online Center will support and promote effective audit committees and position the CPA, who has the competencies, ethics, and experience required of financial experts, as the ideal audit committee member. With the goal of improving corporate governance, the Center will provide guidance to management and boards of directors regarding best practices in appointing and managing the audit committee function.

The Center is divided into three main sections: Audit Committee Toolkits, Audit Committee Matching System, and Guidance and Resources Section.

The **Audit Committee Toolkits** are designed to help audit committees uphold their fiduciary responsibilities with various matrices, questionnaires, sample forms, checklists, and other items. There are *Toolkits* for all organizations—public, private, not-for-profit, and government.

The **Audit Committee Matching System** enables CPAs to find opportunities to provide their financial expertise and commitment to corporate governance as audit committee members, and helps companies and organizations searching for audit committee members locate eligible CPAs.

The Guidance and Resources Section provides information—such as how to improve the audit committee function—and offers resources that aid in evaluating, selecting, and monitoring external relationships.

These resources are available to you at the Audit Committee Effectiveness Center website: aicpa.org/audcommctr/

The *AICPA Audit Committee Toolkit, Not-for-Profit Organizations* is accompanied by a CD-ROM containing the complete *Toolkit* in Microsoft Word, so you can customize the tools to fit your audit committee's needs.

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The AICPA Audit Committee Toolkit Not-for-Profit Organizations, 2nd Edition

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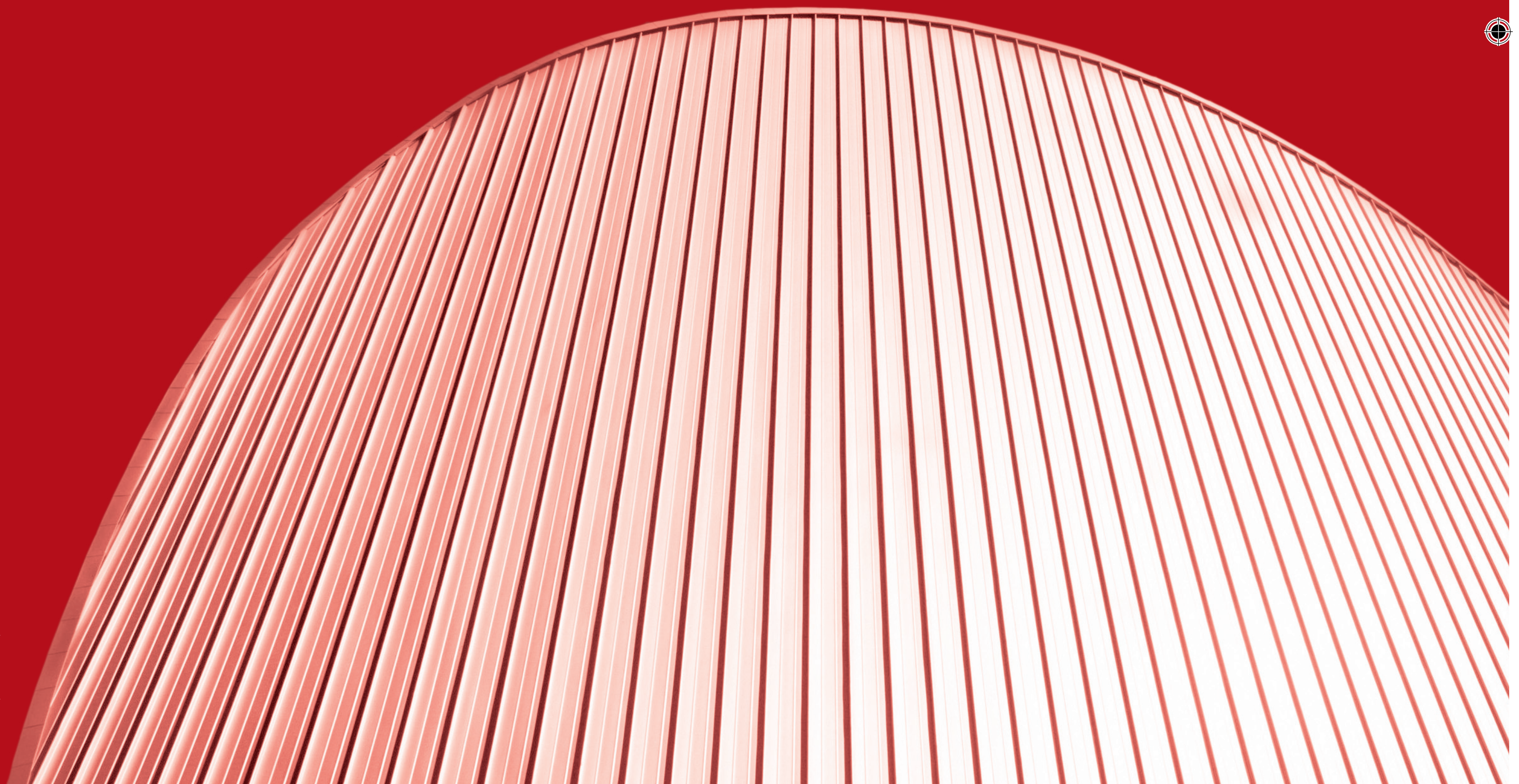
The AICPA Audit Committee TOOLKIT
Not-for-Profit Organizations, 2nd Edition



Audit Committee Effectiveness Center

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The AICPA
Audit Committee
TOOLKIT
Not-for-Profit Organizations, 2nd Edition

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Audit Committee Effectiveness Center

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NOTICE TO READERS

The AICPA Audit Committee Toolkit: Not-for-Profit Organizations material is designed to provide illustrative information with respect to the subject matter covered. It does not establish standards or preferred practices. *The AICPA Audit Committee Toolkit: Not-for-Profit Organizations* material has not been considered or acted upon by any senior technical committee or the AICPA Board of Directors and does not represent an official opinion or position of the AICPA or the sponsors of the toolkit. It is provided with the understanding that the author, publisher, and sponsors are not engaged in rendering legal, accounting, or other professional service. If legal advice or other expert assistance is required, the services of a competent professional should be sought. The author, publisher, and sponsors make no representations, warranties or guarantees as to, and assume no responsibility for the content or application of the material contained herein, and expressly disclaim all liability for any damages arising out of the use of, reference to, or reliance on such material.

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In January 2004, the AICPA launched its Audit Committee Effectiveness Center (center) to provide resources in the public interest to those who work with and serve on audit committees and boards of directors. The center is available at www.aicpa.org/audcommctr. The information provided on the center is intended for use by all organizations: publicly owned, privately owned, not-for-profit, and governmental entities.

The two main features of the center, *The AICPA Audit Committee Toolkit(s)* and the *Audit Committee Matching System*, have helped thousands of organizations effectively carry out corporate governance responsibilities.

This 2nd edition of *The AICPA Audit Committee Toolkit: Not-for-Profit Organizations* has been developed by CPAs working in and with not-for-profit organizations, and is tailored to meet the unique needs of the organizations they serve.

This edition of *The AICPA Audit Committee Toolkit: Not-for-Profit Organizations* is accompanied by a CD-ROM containing all of the tools in Microsoft Word so you can modify and customize them to fit your organization and audit committee's needs.

In addition to this toolkit, there is a toolkit available for public companies, private companies, and government entities.

The foundational component of *The AICPA Audit Committee Toolkit: Not-for-Profit Organizations* is the "Audit Committee Charter Matrix." This matrix and the accompanying checklists, interview guides, questionnaires, and other resources are intended to be used as active tools to help the organization and audit committee execute their responsibilities.

We also encourage you to make use of the *Audit Committee Matching System*, which is a means to link CPAs who are willing to serve as members of boards of directors and audit committees with the organizations that need their unique CPA skill set in these roles.

And finally, another feature of the center is the e-alert option. By registering for e-mail alerts, you will be informed of new tools and updates to existing tools as they are released and other developments that relate to audit committee responsibilities.

We are grateful to CNA for their continued sponsorship and support of the center.

If you have questions, comments, ideas for additional tools, or other feedback, please e-mail our staff at acms@aicpa.org.

Sincerely,

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The AICPA Audit Committee Toolkit: Not-for-Profit Organizations was developed by AICPA members working in and with not-for-profit organizations. We would like to publicly thank the members of the task force and the organizations that provided them the opportunity to participate in this project for their dedication, professional expertise, and hard work.

We specifically would like to recognize the following leaders on the task force:

Ellen Hobby	Task Force Chair
Greg Coy	Charter Matrix Tools Subchair
Cheryl Olson	Other Tools Subchair
Nancy Shelmon	External and Internal Audit Tools Subchair

Finally, we would like to thank Kayla Briggs, AICPA staff liaison, and to recognize CNA for its continued sponsorship, and for making this toolkit and the Audit Committee Effectiveness Center Web site available in support of our members, the organizations that they serve, and the public interest.

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Preface

This toolkit was designed for use by individuals and not-for-profit organizations that represent varying degrees of technical experience with not-for-profit audit committees. The following executive summary is intended to provide a general overview for all readers to gain a broad understanding of how to use the toolkit to maximize their understanding of roles and requirements that may be tailored to their specific and unique circumstances.

This toolkit is designed for use by the following groups:

- All not-for-profit organizations regardless of size
- Board and audit committee members of not-for-profit organizations
- CEO, CFO, chief audit executives, and other key staff positions of a not-for-profit organization
- External and internal auditors

The toolkit has been organized into the following subgroups:

- General considerations
- Management and the organization
- Internal control and internal audit
- External auditors and resources

I. Audit Committee—General Considerations

Audit Committee Charter Matrix

This matrix is designed as a checklist for audit committees to consider using annually to assist when documenting compliance with outlined roles and responsibilities.

Audit Committee Member Roles and Responsibilities

This section outlines the basic responsibilities of an audit committee that organizations should consider when selecting members to participate in an audit committee. This section also provides a sample matrix of the defined roles of both the audit committee and finance committee of a not-for-profit organization.

Audit Committee Financial Expertise Considerations

Much has been said about the need for the audit committee to have “financial expertise.” This section outlines the major components that define *financial expertise*, and whether the committee has the necessary expertise to fulfill its duties for a not-for-profit organization.

Enterprise Risk Management—The COSO Framework: A Primer and Tool for the Audit Committee

This tool provides an introduction and summary to the key aspects that audit committees should consider related to a not-for-profit organization’s enterprise risk management.

Conducting an Audit Committee Executive Session: Guidelines and Questions

This section defines an *executive session* and provides a sample matrix of questions to consider when conducting an executive session.

Conducting an Audit Committee Self-Evaluation: Guidelines and Questions

This checklist may be utilized on an annual basis to help determine the fulfillment of the responsibilities of the audit committee.

II. Audit Committee—Management and the Organization

Independence and Related Topics: Conflict of Interest, Related Parties, Inurement, and Other Issues

The topics discussed in this tool are critical for not-for-profit organizations and provide a foundation for participation in and involvement with transactions related to not-for-profit organizations for both staff and volunteers. This section provides guidance for audit committees in handling these key issues and contains a sample conflict of interest policy.

Sample Document Retention and Destruction Policy

This section provides a sample retention schedule for not-for-profit organizations and audit committees to use for guidance on retaining and disposing of key records and documents.

Unique Transactions and Financial Relationships

This tool discusses the audit committee's responsibilities and considerations related to a not-for-profit organization's financial transactions and relationships, including a sample set of questions for use by audit committees.

Significant Issues, Estimates, and Judgments: Management's Report to the Audit Committee

This tool provides an overview and examples pertaining to the discussion of significant issues, estimates, and judgments between management and the audit committee.

III. Audit Committee—Internal Control and Internal Audit

Internal Control: A Tool for the Audit Committee

Understanding the internal control environment and structure is vital for not-for-profit audit committees. This tool provides assistance to audit committees both in their understanding of responsibilities related to not-for-profit organization internal control structures and practical advice on how the audit committee provides oversight to these organizations.

Fraud and the Responsibilities of the Audit Committee: An Overview

This tool gives audit committees a summary on their responsibilities related to potential fraud in a not-for-profit organization.

Sample Whistle-Blower Tracking Report

This section provides a sample tracking report for use by audit committees with respect to a formal whistle-blower policy of not-for-profit organizations.

Guidelines for Hiring the Chief Audit Executive

Depending upon a number of factors, not-for-profit organizations may need a separate internal audit function. This tool provides guidelines to the audit committee in the hiring of a chief audit executive for not-for-profit organizations.

Evaluating the Internal Audit Team: Guidelines and Questions

Audit committees should evaluate the internal audit teams of not-for-profit organizations. This tool provides sample questions to use during while reviewing the internal audit department.

IV. Audit Committee—External Auditors and Resources

Sample Request for Qualifications and Request for Proposal Letter for CPA Services

This section provides a sample letter that requests services from a CPA that can be used and tailored by the audit committee when requesting such services (audit, tax, consulting).

Evaluating the Auditor's Engagement Letter: Questions to Consider

This checklist is designed to assist audit committees with the review of the auditor's engagement letter for the scope of services to be performed by an external auditor.

Required Communications with the External Auditors: What to Expect

This tool provides an overview of the typical discussions between the audit committee and the external auditors.

Evaluating the External Auditors: Questions to Consider

This section provides a sample checklist to follow when evaluating external auditors upon the completion of the annual audit.

Single Audits—Office of Management and Budget Circular No. A-133: Audits of States, Local Governments, and Non-Profit Organizations

This section provides information related to the risks associated with and the compliance by not-for-profit organizations that accept federal awards.

Peer Review of CPA Firms: An Overview

This tool provides information related to CPA firms and their peer review process.

Points to Consider When Engaging External Experts and Advisors

This tool is designed to assist audit committee members when engaging external experts and advisors, if needed.

Appendix A: Resources for Audit Committees

This appendix provides additional resources related to not-for-profit audit committees.

Appendix B: Analytical Procedures for Not-for-Profit Organizations

This appendix illustrates four analytical procedures taken from the course *Analytical Procedures for Nonprofit Organizations*.

Appendix C: Sample Not-for-Profit Audit Committee Charter

This appendix provides sample language that may be used by an organization in developing an audit committee charter.

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PART I: Audit Committee—General Considerations

Audit Committee Charter Matrix

PURPOSE OF THIS TOOL: Adopting and maintaining an audit committee charter is a best practice for not-for-profit organizations. It is required by some states for not-for-profit organizations. However, the charter is often adopted and filed away except for its annual review. This tool is designed to help audit committees make the charter a living document and use it to manage the agenda.

This tool is meant as a sample of a best practice. Users of the tool should put their own charter in the first column and use this example as a guide for defining the steps to accomplish each objective, the associated performance measure, and the scheduling.

This tool is intended to serve not-for-profit organizations of all sizes and organizational structures. For instance, some small not-for-profit organizations cannot justify the expense of an internal auditor, whereas others have very large internal audit departments headed by a senior executive. Similarly, relatively few not-for-profit organizations employ in-house legal counsel. Instead, most not-for-profit organizations rely on the professional services of outside attorneys engaged on a retainer basis or rely on volunteers' services. The guidance provided in this tool is applicable whether in-house resources are employed, an outsource arrangement exists, or volunteers provide services.

Not-for-Profit Audit Committee Charter Matrix
For the Year Ending: ____________

I. Audit Committee Charter—General Considerations

Audit Committee Charter General Considerations	Steps to Accomplish Objective (Checklist)	Deliverable	When to Achieve (Frequency/Due Date)	Date Completed
I-A. Audit Committee Charter				
Establish an audit committee charter with approval from the board. The charter should set forth audit committee member roles and responsibilities. Review the committee's charter annually, reassess the adequacy of this charter, and recommend any proposed changes to the board of directors. Consider changes that are necessary as a result of new laws, regulations, and best practices. (See the tool "Audit Committee Member Roles and Responsibilities" and appendix C in this toolkit.)	Review the charter each year. Assess the appropriateness and completeness of the charter in light of the previous year's experience, new best practices, and new legal or regulatory requirements.	Report to the board on the appropriateness of the charter and recommend any revisions for approval by the board.	Review annually, unless changes are needed during the course of the year.	
I-B. Audit Committee Financial Expertise Considerations				
The audit committee should have access to financial expertise, whether in the form of a single individual serving on the committee, or collectively among committee members. If the financial expertise is provided by one individual, it is desirable that he or she be a member of the board of directors. When no single member of the board has the requisite skills, other arrangements should be made to ensure that the audit committee has the financial expertise to carry out its duties.	Ascertain that the committee has the requisite financial expertise as defined by the organization.	Indicate in audit committee meeting minutes how financial expertise is available to the committee.	Affirm annually and when there is a change in status.	

I. Audit Committee Charter—General Considerations *(continued)*

Audit Committee Charter General Considerations	Steps to Accomplish Objective (Checklist)	Deliverable	When to Achieve (Frequency/Due Date)	Date Completed
The committee should undertake education initiatives to improve the financial expertise of the committee as a whole, including attendance at seminars and conferences, special speakers at committee educational sessions, and study of analytical tools for audit committees. (See the tool "Audit Committee Financial Expertise Considerations" and appendix B in this toolkit.)				
I-C. Audit Committee Membership				
The audit committee shall consist of at least three members, and preferably three, five, or seven members. The chair of the audit committee shall be selected from among those members of the audit committee who are also members of the board of directors. All committee members shall be independent in order to serve on this committee. No officer or employee of the organization may serve on the committee. Although not all audit committee members need be members of the board of directors, a majority of the committee members should be members of the board of directors. (See the tool "Independence and Related Topics: Conflict of Interest, Related Parties, Inurement, and Other Issues" in this toolkit.)	Test for independence, based on the policies established by the organization. Minimal independence standards would prohibit employees of the organization or those with direct financial interests in entities serving the organization from serving on the committee. No employee of the organization's external auditors should serve on the committee or on the board of directors.	Indicate in the committee minutes whenever a new member is appointed. Indicate in the committee minutes whenever a new committee chair is elected.	Affirm annually or whenever a change in status by any committee member occurs.	

(continued)

I. Audit Committee Charter—General Considerations *(continued)*

Audit Committee Charter General Considerations	Steps to Accomplish Objective (Checklist)	Deliverable	When to Achieve (Frequency/Due Date)	Date Completed
I-D. Enterprise Risk Management				
Inquire of management, the chief audit executive (CAE), and the external auditors about significant risks or exposures facing the organization; assess the steps management has taken or proposes to take to minimize such risks to the organization; and periodically review compliance with such steps.	Document the material risks that the organization faces related to the organizations financial condition and controls and financial reporting. Update as events occur. Review with management and the CAE on a periodic basis.	Submit a risk report to the board and the external auditors including mitigation strategies and quantifiable risks and insurance to cover such risks, like loss of revenue.	Review at least once each year, and more frequently if necessary.	
Review with the general counsel, external auditors, external counsel, and the CAE, legal and regulatory matters that, in the opinion of management, may have a material impact on the financial statements, related organization compliance policies, and programs and reports received from regulators. (See tool "Enterprise Risk Management—The COSO Framework: A Primer and Tool for the Audit Committee" in this toolkit.)	Discuss whether the organization is in compliance with laws and regulations that govern the environment(s) in which it operates, as well as other applicable laws and regulations.	Report to the board that the review has taken place and any matters that need to be brought to its attention.	Review at least annually.	
I-E. Audit Committee Meetings				
The committee will meet as needed to address matters on its agenda, but not less frequently than twice each year. The committee may ask members of management or others to attend the meeting and provide pertinent information as necessary. The meetings should be scheduled so that the external auditor's engagement letter is approved at one meeting and the final audited financial statements and report of the external auditors are approved at another meeting. Provision for unanimous consent approval of actions should be included in the charter to deal with decisions required between meetings.	In-person meetings should be held at least once each year. All members are expected to attend each meeting in person, via telephone or video conference. Telephone conference meetings may be held more frequently. The agendas for meetings should be prepared and provided to members in advance, along with appropriate briefing materials.	Prepare minutes that document decisions made and action steps following meetings and review for approval. Meeting minutes should be filed with the board of directors.	Minutes should be distributed as soon as possible but no later than before the next meeting.	

I. Audit Committee Charter—General Considerations *(continued)*

Audit Committee Charter General Considerations	Steps to Accomplish Objective (Checklist)	Deliverable	When to Achieve (Frequency/Due Date)	Date Completed
I-F. Audit Committee Annual Agenda and Report				
Create an agenda for the ensuing year, or review and approve the agenda submitted by the CAE.	Use the "Not-for-Profit Audit Committee Charter Matrix" as a sample, and tailor it to your organization.		Review before the upcoming year.	
Oversee the preparation of, or prepare, an audit committee annual report to the board of directors.	Review and discuss the annual report with CAE and auditors.	Annual report finalized and approved. Present to board.	Review annually upon completion of audited financial statements.	
I-G. Conducting an Audit Committee Executive Session				
Conduct executive sessions with each of the external auditors, the CEO, and the CFO. If the organization has a CAE, general counsel, or outside counsel, executive sessions should be conducted with each of these individuals as well. Circumstances may dictate that additional executive sessions may be needed with the director of financial reporting, controller, or others as deemed appropriate by the committee. (See the tool "Conducting an Audit Committee Executive Session: Guidelines and Questions" in this toolkit.)	Establish these sessions in conjunction with regularly scheduled meetings or as necessary.	Develop action steps to be taken, if appropriate. Minutes should generally only reflect that executive sessions took place. Minutes should not be kept of the sessions themselves.	Review as necessary, but not less frequently than regularly scheduled meetings.	
I-H. Conducting an Audit Committee Self-Evaluation				
The committee will review its effectiveness annually. (See the tool "Conducting an Audit Committee Self-Evaluation: Guidelines and Questions" in this toolkit.)	The committee will review its accomplishments and make recommendations for improving its effectiveness.	Discuss recommendations with board of directors.	Review annually.	
I-I. Other Responsibilities				
The committee will perform such other functions as assigned by the organization's charter or bylaws, or the board.			Review new business at all meetings.	

(continued)

II. Audit Committee—Management and the Organization

Audit Committee Charter General Considerations	Steps to Accomplish Objective (Checklist)	Deliverable	When to Achieve (Frequency/Due Date)	Date Completed
II-A. Code of Conduct				
Periodically review the organization's code of conduct/ethics to ensure that it is adequate and up-to-date.	Review results with the CAE and general counsel. Consider any adjustments that may be necessary to the organization's code of conduct/ethics.	Report to the board that the review of the code of conduct/ethics was completed.	Review at least annually.	
Review with the chief audit executive (CAE) and the organization's general counsel the results of their review of the monitoring of compliance with the organization's code of conduct/ethics.	Consider steps that may need to be taken to ensure that compliance is at the highest possible level.	Recommend changes to the code of conduct/ethics to the board as needed.	Review any significant findings as they arise.	
II-B. Document Retention and Destruction Policy				
Establish a document retention and destruction policy. Review it with the CAE, management, the external auditors, and with the board of directors. Review the policy annually to ensure compliance with legal, tax, and regulatory requirements. (See the tool "Sample Document Retention and Destruction Policy" in this toolkit.)	Prepare and approve a policy and review it with the board.	A document retention and destruction policy. An annual review of the policy, recommending amendments as required to comply with legal, tax, and regulatory requirements.	Review the policy annually.	
II-C. Unique Transactions and Financial Relationships				
Review with management and the external auditor the effect of any regulatory and accounting initiatives and unique transactions (including off-balance-sheet transactions). Review accounting for such transactions to ensure best practices are applied. Review significant related party transactions. (See the tool "Unique Transactions and Financial Relationships" in this toolkit.)	Independently, through professional reading and continuing education, keep up-to-date on new developments related to the not-for-profit industry, the organization's specific sector, and the environment in which the organization operates, including any regulatory requirements it may be subject to. Discuss with management and the external auditors in meetings.	Record discussion and any action steps in committee meeting minutes.	Review as necessary.	

II. Audit Committee—Management and the Organization *(continued)*

Audit Committee Charter General Considerations	Steps to Accomplish Objective (Checklist)	Deliverable	When to Achieve (Frequency/Due Date)	Date Completed
II-D. Review of Interim Financial Reports				
Review with management and the CAE, any interim financial reports issued since the last meeting.	Discuss the financial statements with emphasis on changes in reporting, new and unusual transactions, and financial trends.	Record discussion and any action steps in audit committee meeting minutes.	Review as necessary.	
II-E. Issues Report From Management				
Review the following with each public accounting firm that performs an audit: • All critical accounting policies and practices used by the organization. All alternative treatments of financial information within generally accepted accounting principles that have been discussed with management of the organization, the ramifications of each alternative, and the treatment preferred by the organization.	Discuss each matter, and related matters that may come to the attention of the audit committee or the external auditor, or both through this process. Create an action plan and follow-up plan as necessary.	Submit reports and documentation of discussions and resolution of disagreements. Report to the board on significant issues, findings, and actions taken as a result of these reviews.	Review, at least annually/or in conjunction with the year-end audit.	
• Any consultation with audit firms other than the external auditors, including reasons for and results of the consultation. (See the tool “Significant Issues, Estimates, and Judgments: Management’s Report to the Audit Committee” in this toolkit.)				

(continued)

III. Audit Committee—Internal Control and Internal Audit

Audit Committee Charter General Considerations	Steps to Accomplish Objective (Checklist)	Deliverable	When to Achieve (Frequency/Due Date)	Date Completed
III-A. Internal Control: A Tool for the Audit Committee				
Review the following with the external auditors and the chief audit executive (CAE): • The adequacy of the organization's internal controls, including computerized information system controls and security • Any related significant findings and recommendations of the external auditors and internal audit services, together with management's responses thereto (See the tools "Internal Control: A Tool for the Audit Committee" and "Fraud and the Responsibility of the Audit Committee: An Overview" in this toolkit.)	Review the reports of the internal audit team for all audits completed since the prior audit committee meeting. Review key internal controls with the CAE, and understand how these controls will be tested during the year. Review these plans with the external auditor to understand their scope with respect to key controls. Review with the CAE the plans for audits of other elements of the control environment. Determine that all internal control weaknesses are quantified, reviewed, and addressed.	Report to the board on issues relating to internal controls, with emphasis on management's ability to override controls and the monitoring and testing relating to this capacity.	Submit a comprehensive report to the board at a specified meeting each year. Update on anything new, or any changes to the internal control system, at every meeting.	
III-B. Internal Control: Accounting Policies and Procedures				
Ensure that accounting policies and procedures and related controls are documented and reviewed with the committee. Review accounting controls on an annual basis. Review with management the policies and procedures with respect to officers, key employees (CEO, CFO, chief operating officer), disqualified persons as defined by the IRS (under Internal Revenue Code Section 4958), expense accounts and perks, including excess benefit transactions, consider the results of any review of these areas by the internal auditor or the external auditors.	Ensure written policies and procedures exist. Discuss with the CAE, or equivalent, the need for testing by either the internal auditors, external auditors, or other parties.	Report issues, if any, to the board.	Review policies and procedures annually. Review any significant findings as they arise.	

III. Audit Committee—Internal Control and Internal Audit *(continued)*

Audit Committee Charter General Considerations	Steps to Accomplish Objective (Checklist)	Deliverable	When to Achieve (Frequency/Due Date)	Date Completed
III-C. Internal Control: Continuous Monitoring				
Inquire of the CEO and CFO regarding the sources of support and revenue of the organization from a subjective as well as an objective standpoint. (See the tools “Internal Control: A Tool for the Audit Committee” and “Conducting an Audit Committee Executive Session: Guidelines and Questions” in this toolkit.)	Discuss sources of support and revenue with the CEO, CFO, and other executives. Identify any issues addressed, and their resolution. Establish a standing agenda for executive sessions.		Review, as necessary, but at least annually.	
III-D. Fraud and the Responsibility of the Audit Committee				
The committee should review the organization’s antifraud programs and controls and aid in its discovery and remedy if it does occur. The committee helps prevent and discover fraud by • monitoring the financial reporting process. • overseeing the internal control system. • overseeing the internal audit and independent public accounting functions. • reporting findings to the board of directors. • monitoring and overseeing the whistle-blower policy and hotline (See the tool “Fraud and the Responsibilities of the Audit Committee: An Overview” in this toolkit.)	On a periodic basis, the committee should review the major risk exposures of the organization to fraud and the programs and controls to aid in its prevention and discovery. The committee should review all instances of fraud to determine enhancements to antifraud programs and controls.	Report to the board on a periodic basis on the condition of the organization’s risk exposure to fraud and the organization’s antifraud programs and controls.		
III-E. Whistle-Blower Tracking				
Review the procedures for the receipt, retention, and treatment of complaints received by the organization regarding accounting, internal accounting controls, or auditing matters that may be submitted by any party internal or external to the organization. Review any complaints that might have been received, current status, and resolution if one has been reached. (See tool “Sample Whistle-Blower Tracking Report” in this toolkit.)	Review procedures with CAE, external auditors, and the general counsel. Review all complaints that have been received and the status of resolution. Ensure that proper steps are taken to investigate complaints and resolve them in a timely fashion.	Review an original of each complaint received no matter the media used to submit. Discuss the status of resolution of each complaint. Review a cumulative list of complaints submitted to date to review for patterns or other observations.	Review at least annually.	

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III. Audit Committee—Internal Control and Internal Audit *(continued)*

Audit Committee Charter General Considerations	Steps to Accomplish Objective (Checklist)	Deliverable	When to Achieve (Frequency/Due Date)	Date Completed
III-F. The Chief Audit Executive				
The committee is responsible for guiding, reviewing, and approving the appointment, replacement, reassignment, or dismissal of the CAE. The CAE should report functionally to the audit committee and administratively to a senior executive of the organization, typically the CEO or the CFO. The committee chair should meet with the CAE between meetings either in person or by telephone. The committee should evaluate the performance of the CAE annually. (See the tool "Guidelines for Hiring the Chief Audit Executive " in this toolkit.)	Meet in executive session at each meeting with the CAE. Hold special meetings as may be necessary to address appointment, reassignment, or dismissal of CAE. The committee chair should be available if any unforeseen issues arise between meetings relating to the CAE. Meet at least once annually with other members of executive management and the external auditors to discuss the performance of CAE. Discuss job satisfaction and other employment issues with the CAE.	Report to the full board on the performance of the CAE, including the effectiveness of the internal audit function.	Conduct ongoing reviews, as changes can be made at any time during the year.	
III-G. Internal Audit Scope and Plan				
Review with the external auditor, CFO, controller, and CAE the audit scope and plan of the internal auditors. Address the coordination of audit efforts to assure the completeness of coverage, reduction of redundant efforts, and the effective use of audit resources. The committee should discuss with the CAE and the external auditors opportunities for reliance by the external auditors on the audit activities of internal audit.	Meet with external audit partner, CFO, controller, and CAE to discuss scope of the previous year's audit, and lessons learned. Later, discuss planned scope for audit of current year and the standard of work to be followed. In addition, discuss the timing of progress reports, to be provided by the external auditors, and the communications process to be followed in the event of deviations from the plan.	Document the meeting in the audit committee meeting minutes.	On an annual basis, review the scope of the previous year's audit, and the inter-relationship between the internal and external auditors with respect to the scope of the external auditors' work. At another of the meetings each year, review the plans of internal audit for audits in the current year, if applicable.	

III. Audit Committee—Internal Control and Internal Audit *(continued)*

Audit Committee Charter General Considerations	Steps to Accomplish Objective (Checklist)	Deliverable	When to Achieve (Frequency/Due Date)	Date Completed
III-H. Review of Internal Audits				
Consider reviewing the following with management and the CAE: • Significant findings on internal audits during the year and management's responses thereto • Whether internal audit encountered any difficulties in the course of its audits, such as any restrictions on the scope of its work or access to required information • Any changes required in the scope of its internal audit • The internal audit department's budget and staffing • The internal audit department's charter Internal Audit's compliance with the Institute of Internal Auditors' (IIA's) Standards for the Professional Practice of Internal Auditing (standards), if applicable. Internal audit should meet separately with the external auditors to coordinate audit plans to optimize the ability of the external auditor to rely upon the results the internal audit team.	Review reports of all internal audits issued since the previous meeting and planned for the upcoming year along with the status of each planned audit. Review and discuss the findings for each audit completed since the prior meeting, and management's response to the report. Discuss internal audit department budget and staffing with the CAE. Discuss internal audit's compliance with IIA standards, if applicable, including the requirement for a peer review once every five years. If the organization receives federal funds, internal audit is required to have a peer review once every three years if the external auditors plan to rely on their work to reduce the external audit scope. Review the internal audit charter periodically and update, if necessary.	Report on the status of all internal audits planned for the next quarter or year, or both. Internal audit should provide a summary of findings for completed audits, including management's plan to address findings and weaknesses identified.	Review at each meeting.	

(continued)

III. Audit Committee—Internal Control and Internal Audit *(continued)*

Audit Committee Charter General Considerations	Steps to Accomplish Objective (Checklist)	Deliverable	When to Achieve (Frequency/Due Date)	Date Completed
III-I. Evaluating the Internal Audit Team: Guidelines and Questions				
Evaluate the performance of internal audit annually, if applicable, including the adequacy of the audit plan, the management of the execution of the audit plan, the adequacy of the human and other resources available to execute the plan, the ability of the external auditors to rely upon the internal audit work product in its annual audit, and the nature of the findings/results of the internal audits. (See the tool "Evaluating the Internal Audit Team: Guidelines and Questions" in this toolkit.)	Use information from executive sessions conducted throughout the year. Use a formal assessment tool for each group.	Submit recommendations for change in process and procedures.	Review after completion of the annual audit.	
IV. Audit Committee—External Auditors and Resources				
IV-A. External Auditors				
Subject to approval by the board of directors, the committee selects and appoints the external auditors to be engaged by the organization. The committee will approve the audit plan, establish the audit fees of the external auditors, and preapprove any nonaudit services provided by the external auditors, including tax services, before the services are rendered. Review with management the significance of bidding out audit services. Evaluate the performance of the external auditors on an annual basis. Ensure that single audit obligations are incorporated into the annual audit plan.	At least once each year, discuss each of these items with management, the chief audit executive (CAE), and the board of directors. Review total audit fee in relation to any nonaudit services being provided by the external auditor. Review and evaluate the professional relationship with the auditors, including continuity of partner, manager, and staff; and level of service provided by auditors.	Document these discussions in the audit committee meeting minutes. Report on findings and provide recommendations to the board as considered necessary.	Review soon after the audit has been approved by the board, so the recommendation for the appointment of the outside auditor in the next fiscal year can be documented in the board minutes.	

IV. Audit Committee—External Auditors and Resources *(continued)*

Audit Committee Charter General Considerations	Steps to Accomplish Objective (Checklist)	Deliverable	When to Achieve (Frequency/Due Date)	Date Completed
(See the tools "Sample Request for Qualifications and Request for Proposal Letter for CPA Services," "Evaluating the Auditor's Engagement Letter: Questions to Consider," "Peer Review of CPA Firms: An Overview," and "Single Audits—Office of Management and Budget Circular No. A-133: Audits of States, Local Governments, and Non-Profit Organizations" in this toolkit.)	Review the scope of all services provided by the audit firm throughout the organization.			
IV-B. Discussions With the External Auditors				
Review all material written communications between the external auditors and management, such as any management letter or schedule of unadjusted differences. (See the tool "Required Communications with the External Auditors—What to Expect" in this toolkit.)	Discuss each item with the external auditors and management (including the CAE) and conclude on the appropriateness of the proposed resolution.	Submit reports and documentation of discussions, resolution of issues, and the action plan for any items requiring follow-up and monitoring.	Review at the completion of the external audit.	
IV-C. Evaluating the External Auditors: Questions to Consider				
The committee will annually evaluate the external auditors. Communications with the external auditors in the evaluation should respect the need to maintain the open flow of communication between the external auditors and the committee. (See the tool "Evaluating the External Auditors: Questions to Consider" in this toolkit.)	Use information from executive sessions conducted throughout the year. Use a formal assessment tool.	Submit recommendations for change in process and procedures. Request proposals if changes are being considered.	Review after completion of the annual audit.	

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IV. Audit Committee—External Auditors and Resources *(continued)*

Audit Committee Charter General Considerations	Steps to Accomplish Objective (Checklist)	Deliverable	When to Achieve (Frequency/Due Date)	Date Completed
IV-D. Annual Audit—Review				
Review the following with management and the external auditors: • The organization's annual financial statements and related footnotes • The external auditors' audit of the financial statements and their report thereon • The external auditors' judgments about the quality, not just the acceptability, of the organization's accounting principles as applied in its financial reporting • Any significant changes required in the external auditors' audit plan • Any serious difficulties or disputes with management encountered during the audit	Discuss each matter, and others that may come to the attention of the audit committee through this process, with management (including the CAE) and the external auditors. Review with management the course of action to be taken for any action requiring follow-up. Monitor any follow-up action that requires continued audit committee intervention.	Submit reports and documentation of discussions, resolution of disagreements, or action plan for any item requiring follow-up.	Review at the completion of the annual external audit.	
Matters required to be discussed by Statement of Auditing Standards No. 114, *The Auditor's Communication With Those Charged With Governance* (AICPA, *Professional Standards*, vol. 1, AU sec. 380), as amended, related to the conduct of the audit. (See the tool "Required Communications with the External Auditors—What to Expect" in this toolkit.)				

IV. Audit Committee—External Auditors and Resources *(continued)*

Audit Committee Charter General Considerations	Steps to Accomplish Objective (Checklist)	Deliverable	When to Achieve (Frequency/Due Date)	Date Completed
The audit committee shall be authorized to hire external auditors, counsel, or other consultants as necessary. (This may take place any time during the year.) In particular, this may be required to fully explore any issues arising through the whistle-blower procedure. Many organizations receive funding support from governmental and other regulated agencies that may require statutory or contractual procedures when engaging external resources. (See the tools "Points to Consider When Engaging External Experts and Advisors" and "Sample Request for Qualifications and Request for Proposal Letter for CPA Services" and appendix A in this toolkit.)	Establish a policy for the audit committee to preapprove engaging external auditors and other experts. Discuss whether a standing budget should be established for this purpose. Requests for proposals should be used if time permits.	Prepare an engagement letter for each engagement. Report submitted by external accountant, counsel, or consultant.	Continually review the policy and compliance with it as needed.	

Audit Committee Member Roles and Responsibilities

PURPOSE OF THIS TOOL: The following information illustrates how the audit committee might be structured and assigns roles and responsibilities between the audit committee and finance committee.

Not-for-profits should carefully consider the roles and responsibilities for both the formation of the committee and the members considered for the committee. Not-for-profits should tailor the committee's roles and responsibilities to best fit the organization considering the following:

- Size of the organization
- Diversity of organizational revenues
- Complexity of financial position and statements
- Geographic footprint of the organization's staff and mission

The organization should consider having a minimum of three members of its audit committee with at least one of the members being a board member or one member having financial expertise, or both. Furthermore, the organization should carefully consider the state requirements on the number of its members serving the audit committee and the finance committee (for example, California requires organizations to have more than half of its audit committee to be independent of the finance committee). The audit committee generally assists the board in its oversight of the following:

- Integrity of the organization's financial statements
- Internal control over the financial reporting process
- External auditor's qualifications, independence, and performance
- Performance of the internal audit function
- Compliance with legal and regulatory requirements
- Review of (or delegation thereof) the IRS Form 990

Specific responsibilities for an audit committee are typically set forth in the organizations *Financial Policy Manual* (or an audit committee charter), which should be approved by the board of directors. Audit committee charters will vary by organization due to factors such as size, type of not-for-profit, and complexity of the organization's business model.

The following is an illustrative list of responsibilities for audit committee members:

Audit Committee Process and Procedures

- Develop audit committee charter
- Conduct annual review of the audit committee charter
- Develop annual calendar based upon audit committee charter that ties to the board calendar

- Set agenda for the audit committee meetings based upon the audit committee charter
- Determine audit committee information and communication framework (that is, information requirements from management, reports, format, and timeliness)
- Ensure meeting minutes are prepared, documented, and approved by the audit committee
- Provide reports to the board of directors
- Educate the other board members on the understanding of the financial statements and financial statements risks
- Prepare annual audit committee report
- Conduct annual self-assessment of effectiveness and efficiency of the audit committee and evaluation
- Review organization's procedures for reporting of problems, including whistle-blower hotline and other communication methods
- Determine audit committee's process for "special investigations" (that is, whistle-blower allegation, antifraud plan compliance, discovery of error, illegal acts, and so on)
- Review reports from internal audit function
- Aware of legal and regulatory requirements for financial reporting and auditing of financial statements
- Review of IRS Form 990

Oversight of the Financial Reporting Process

- Meet privately and separately with CEO, CFO, independent external auditor, chief audit executive, General Counsel, senior management, and audit committee members only, and others as appropriate to the organization (executive sessions)
- Review critical accounting policies, practices, judgments, estimates, significant issues, significant transactions, adjustments, unusual items, complex issues, and business arrangements
- Review annual audited financial statements including any federal Office of Management and Budget (OMB) A-133 reports
- Review information provided to watchdog agencies
- Obtain explanations from management on all significant variances
- Question management and external auditor on significant financial reporting issues
- Facilitate the resolution of disagreements between management and the external auditor regarding financial reporting
- Determine when a subject matter expert is required and hire advisors when needed
- Determine and designate the audit committee's financial expertise (or designee)
- Oversee system for compliance with legal and regulatory requirements (for example, OMB circulars, state fundraising and licensing)
- Oversee adequacy of the organization's system of internal control
- Review management letters containing the recommendations of the external auditor and management's responses

Oversight of the External and Internal Audit Functions

- Provide pre-approval of all audit and permitted nonaudit services performed by the external auditor
- Appoint or replace external auditor
- Concur in the appointment of the chief audit executive—internal audit
- Review audit plan and scope of audit to be conducted by internal audit and external auditor
- Conduct evaluations of internal auditor and external auditor
- Oversee system of risk assessment and risk management as determined by the board of directors (audit committee primarily focused on financial risk)

Limitation of Audit Committee's Role

Although the audit committee has the responsibilities set forth in a charter, it is not the responsibility of the audit committee to plan or conduct routine audits or to be the primary determinant that the organization's financial statements and disclosures are complete and accurate and are in accordance with generally accepted accounting principles and applicable rules and regulations. These tasks are the responsibility of management and the external auditor, and the audit committee has an oversight responsibility to see that the objective is achieved.

Audit Committee Versus Finance Committee[1]

In general, the finance committee monitors financial transactions and the audit committee makes sure things are done according to policy and with adequate controls. Also, the finance committee provides guidance about what can be done; the audit committee ensures that independent oversight occurs. Therefore, duties are generally assigned as follows:

Audit Committee	Finance Committee
The audit committee	The finance committee
(a) reviews the financial statements of the organization and other official financial information provided to the public;	*(a)* oversees the preparation of the annual budget and financial statements. The finance committee ensures that budgets and interim financial statements are prepared;
(b) has oversight for ensuring that reports are received, monitored, and disseminated appropriately;	*(b)* oversees the administration, collection, and disbursement of the financial resources of the organization as well as the policies and procedures related to the financial resources;

(continued)

[1] Originally published as *What's The Difference? Audit Committee vs. Finance Committee*, this paper has been adapted and edited with the consent of the Nonprofit Risk Management Center at www.nonprofitrisk.org.

Audit Committee	Financial Committee
(c) provides oversight of the organization's systems of internal controls, including overseeing compliance by management with applicable policies and procedures and risk management (for example, for organizations that are part of a national network, annually reviewing whether the organization meets the re-chartering requirements of its national organization);	*(c)* advises the board with respect to making significant financial decisions;
(d) oversees the annual independent audit process, including the recommended engagement of the external auditor and receiving of all reports, and management letters, from the independent certified public accountants;	
(e) reviews the annual information returns, (IRS Form 990, related schedules, and forms) and recommends for approval, signature, and submission by the appropriate officer. The audit committee also transmits the returns to the board for its review prior to signing and submission. The audit committee engages (on the board's behalf) and interacts with the external auditor or auditing firm. Many audit firms also prepare the federal and state tax returns for their nonprofit audit clients; and	*(e)* oversees the preparation and implementation of the governance policies referenced in the Form 990: conflict of interest, document retention, whistle-blower, review of executive compensation, endowments, investments, and so on; and
(f) reviews the organization's procedures for reporting problems. The audit committee may exercise primary responsibility to review the whistle-blower policy and process, anti-fraud policies, and policy and procedures related to the discovery of errors or illegal acts, whistle-blower hotline, and other communication methods and determine the process for "special investigations" (whistle-blower allegations, anti-fraud compliance, discovery of errors or illegal acts).	*(f)* should ensure that joint membership between the audit committee and the finance committee is appropriate and meets local laws and regulations.
The audit committee shall have such other authority and perform such other duties as may be delegated to it by the board.	

Some joint membership between the audit committee and the finance committee may exist. Organizations should refer to state or other local government laws and regulations to ensure compliance.

Certain states may have legal requirements or other regulations that require certain members of the audit committee that are not also members of the finance committee (some states require that the chair of the finance committee not be a member of the audit committee). The purpose is to promote independence within the organization.

Each organization will need to consider these roles and responsibilities, as well as the structure of their organization, and may need to reassign responsibilities, as needed.

Audit Committee Financial Expertise Considerations

PURPOSE OF THIS TOOL: The following information illustrates how the audit committee might approach ensuring it has access to requisite financial expertise.

Audit Committee Financial Expertise

The inclusion of at least one audit committee member with financial expertise (as described subsequently) is a highly recommended best practice.

The following attributes are all deemed to be essential components of financial expertise:

- An understanding of generally accepted accounting principles, generally accepted auditing standards, and financial statements
- The ability to assess the general application of such principles and standards in connection with the accounting for estimates, accruals, and reserves
- Experience preparing, auditing, analyzing, or evaluating financial statements that present a breadth and level of complexity of accounting issues that can reasonably be expected to be raised by the organization's financial statements, or experience actively supervising (that is, direct involvement with) one or more persons engaged in such activities
- An understanding of internal control and procedures for financial reporting
- An understanding of audit committee functions
- A general understanding of not-for-profit financial issues and specific knowledge of the not-for-profit industry (for example, health care or education) in which the organization participates

The following questions should be used to assess whether an individual audit committee member, or the committee as a whole, possesses the previously stated attributes:

- Does state law include certain requirements of audit committees regarding independence, expertise, membership and shared responsibilities with the finance committee, and so on?
- Have one or more individuals completed a program of learning in accounting or auditing?
- Do one or more individuals have experience as a chief or principal financial officer (for example, finance director or business manager), principal accounting officer, controller, public accountant, or auditor?
- Do one or more individuals have experience in position(s) that involve the performance of similar functions?
- Have one or more individuals gained experience by actively supervising a person(s) performing one or more of these functions?
- Do one or more individuals have experience overseeing or assessing the performance of companies, not-for-profit organizations, or public accountants with respect to the preparation, auditing, or evaluation of financial statements?

- Do one or more individuals have other relevant financial experience (for example, service on boards of banking or investment institutions or experience as a banker or investment advisor)?
- Do one or more individuals have experience serving on audit committees of other not-for-profit organizations?

Alternative Approaches

If no individual member of the audit committee possesses the attributes required for financial expertise and the committee members collectively do not possess such attributes, several of the following options might be considered:

- Potential volunteers with financial expertise have limited time to commit to an organization. They might, for example, have time to attend one or two meetings per year, but not a monthly board meeting. Therefore, especially for smaller not-for-profit organizations, it may be beneficial, if bylaws allow it, to open up membership of the audit committee to persons who are not also members of the board of directors or trustees.
- Establish a relationship with a peer or an otherwise comparable organization to have the CFO for one organization provide financial expertise to the other. Such arrangements can be reciprocal or involve multiple organizations.
- Establish an outsource relationship in which a financial professional is engaged and compensated to provide financial expertise as a consultant to the audit committee. Such an individual must otherwise be independent with respect to the organization (that is, must have no other financial arrangements with the organization).
- Pursue a training program for audit committee members to develop the financial expertise. Such training can include participation in professional development programs offered by the AICPA, associations serving the not-for-profit industry, or the specific industry in which the organization participates, or the conduct of in-house training programs.

Resources

Various organizations provide information to support audit committees in carrying out their responsibilities. In addition to this toolkit, the AICPA maintains an Audit Committee Effectiveness Center. Independent Sector has devoted significant attention to issues related to financial expertise, as have industry organizations such as the National Association of College and University Business Officers. Many public accounting firms provide information on these subjects as well. Although its provisions are not directly applicable to not-for-profit organizations, the "SEC Rule on Audit Committee Financial Experts" contains information that may be of interest. Not-for-profit organizations, especially organizations doing business in or soliciting funds in California, should become familiar with the requirements of the California Nonprofit Integrity Act of 2004. A summary of the act can be found at http://ag.ca.gov/charities/publications.php. Other states also have laws and regulations related to audit committee functions. Audit committee members should read and understand any laws and regulations in all states where their organization does business.

See appendix A of this toolkit for additional information about resources.

Enterprise Risk Management—The COSO Framework: A Primer and Tool for the Audit Committee

PURPOSE OF THIS TOOL: Historically, risk management efforts in most organizations have been focused on preventing losses of physical or financial assets at the operational level. However, organizations now recognize the linkage between governance, enterprise risk management (ERM), and organization performance.

ERM is an attempt to manage risk in a comprehensive manner that is aligned with the strategic direction of the organization and integrated with the everyday management of the organization. Many organizations, their boards, and audit committees are beginning to view risk management from this strategic perspective and consider risk management oversight to be a critical element of governance.

This tool is intended to give boards an overview of ERM, its opportunities and limitations, the relationship between ERM and internal control, and the roles and responsibilities for risk management in the organization. Importantly, ERM is a management reponsibility, subject to oversight of the board of directors.

ERM Primer—Basics of ERM and its Relationship to Internal Control

In September 2004, the Committee of Sponsoring Organizations[1] of the Treadway Commission (COSO) published a document called *Enterprise Risk Management—Integrated Framework*,[2] which defined ERM as follows:

> Enterprise risk management is a process, effected by an entity's board of directors, management and other personnel, applied in a strategy setting and across the enterprise, designed to identify potential events that may affect the entity, and manage risk to be within its risk appetite, to provide reasonable assurance regarding the achievement ot entity objectives.

The ERM framework is geared to achieving an organization's objectives, set forth in the following four categories:

1. *Strategic.* High-level goals, aligned with and supporting its mission.
2. *Operations.* Effective and efficient use of its resources.
3. *Reporting.* Reliability of reporting.
4. *Compliance.* Compliance with applicable laws and regulations.

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[1] The Committee of Sponsoring Organizations of the Treadway Commission (COSO) consists of the AICPA, the Institute of Management Accountants, the Institute of Internal Auditors, Financial Executives International, and the American Accounting Association.

[2] The COSO publication *Enterprise Risk Management—Integrated Framework* (product code no. 990015), may be purchased through the AICPA store at www.cpa2biz.com. The proceeds from the sale of the framework are used to support the continuing work of COSO.

The COSO ERM framework consists of eight interrelated components as follows:

1. *Internal environment.* The internal environment sets the foundation for how risk is viewed and addressed by an organization's people, including risk philosophy and risk appetite, integrity and ethical values, and the environment in which they operate.
2. *Objective setting.* Objectives must exist before management can identify potential risks affecting their achievement. ERM ensures that management has in place a process to set objectives and that the chosen objectives support and align with the entitiy's mission and are consistent with its risk appetite.
3. *Event identification.* Internal and external events affecting the achievement of an organization's objectives must be identified, distinguishing between risks and opportunities.
4. *Risk assesment.* Risks are analyzed, considering likelihood and impact, as a basis for how they should be managed. Risks are assessed on an inherent and residual basis.
5. *Risk response.* Management selects risk responses—avoiding, accepting, reducing, or sharing risk—developing a set of actions to align risks with the organization's risk tolerances and risk appetite.
6. *Control activities.* Policies and procedures are established and implemented to help ensure the risk responses are effectively carried out.
7. *Information and communication.* Relevant information is identified, captured, and communicated in a form and time frame that enables people to carry out their responsibilities. Effective communication also occurs in a broader sense, flowing down, across, and up the organization.
8. *Monitoring.* The entire ERM process is monitored and modifications are made as necessary. Monitoring is accomplished through ongoing management activities, separate evaluations, or both.

ERM is not a serial process, but a multidirectional iterative process with the eight components impacting each other. Likewise, the eight components will not function identically in every organization. Application in small and medium-sized organizations likely to be less formal and less structured.

The components are the criteria for the effectiveness of ERM. When each of the eight components is determined to be present and functioning effectively, and risk has been brought within the organization's risk appetite, management and the board of directors have reasonable assurance that they understand the extent to which each of the four categories objectives is being achieved by the organization.

Relationship Between COSO *Enterprise Risk Management—Integrated Framework* and *Internal Control—Integrated Framework*

In 1992, COSO published a document called *Internal Control—Integrated Framework*,[3] which established a comprehensive framework for internal control. In 2006, COSO issued its publication *Internal Control over Financial Reporting—Guidance for Smaller Public Companies*,[4] which provides guidance on how to apply the original framework, particularly as it relates to the objectives of financial reporting.

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[3] The COSO publication *Internal Control—Integrated Framework* (product code no. 990012), may be purchased through the AICPA store at www.cpa2biz.com. The proceeds from the sale of the framework are used to support the continuing work of COSO.

[4] The COSO publication *Internal Control over Financial Reporting—Guidance for Smaller Public Companies* (product code no. 990017), may be purchased through the AICPA store at www.cpa2biz.com. The proceeds from the sale of the framework are used to support the continuing work of COSO.

Internal Control—Integrated Framework remains in place as a tool for evaluating internal control by itself and is also encompassed within ERM. The relationship between internal control and ERM is possibly best captured by the phrase: "you can have effective internal control without effective enterprise risk management, but you cannot have effective enterprise risk management without effective internal control."

Internal control is an integral part of ERM, which is a broader conceptual tool, expanding and elaborating on internal control, focusing more fully on risk, especially as it relates to strategic considerations.

Certain of the key areas where the ERM framework expands on the internal control framework include the following:

Objectives. The internal control framework specifiec three categories of objectives—operations, financial reporting, and compliance. The ERM framework adds strategic objectives and expands the reporting objective to cover all reports developed and disseminated internally or externally, and expands the scope to cover nonfinancial information.

Environment. The ERM framework discusses an organization's risk management philosphy, which is the set of shared beliefs and attitudes characterizing how an organization considers risks, and reflects its culture and operating style.

Key components of a risk management philosophy are *risk appetite* and *risk tolerences*. *Risk appetite*, set by management with oversight by the board of directors, is a broad-based conceptualization of the amount of risk that an organization is willing to take to achieve its goals. An organization's risk appetite serves as a guidepost for making strategic choices and resource allocation decisions that are consistent with its established risk appetite.

The risk appetite is supported by more specific *risk tolerences* that reflect the degree of acceptable variation in executing the organization's activities. Risk tolerences are usually best measured in the same units as the objectives that they relate to, and are aligned with the overall risk appetite.

The ERM framework also introduced the notion of taking a *portfolio view of risk*—looking at the composite of organization risks from a "portfolio" perspective. A portfolio view of risk can be depicted in a variety of ways. A portfolio view may be gained from looking at major risks or event categories across units, or by focusing on risk for the organization as a whole using net assets, changes in net assets, or other metrics. Taking a portfolio view enables management to determine whether it remains within its risk appetite, or whether additional risks should be accepted in some areas in order to enhance returns.

Risk assessment and response. In addition to considering risk from a "portfolio" perspective, the ERM framework calls attention fo interrelated risks, when a single event or decision may create multiple risks.

The framework also identifies four categories of risk response that are taken into consideration by management in looking at inherent risks and achieving a residual risk level that is in line with the organization's risk tolerences and overall risk appetite.

The following are the four risk response categories:

1. *Avoidance.* Not engaging in activities giving rise to the risk or exiting those activities.
2. *Reduction.* Any action taken to reduce risk likelihood, impact, or both.

3. *Sharing.* Reducing risk likelihood or impact by transferring or otherwise sharing a portion of the risk. Insurance products, hedging transactions, and outsourcing are common examples.
4. *Acceptance.* No action is taken to affect risk likelihood or impact.

Other Key Terms in ERM

You will hear a few additional terms when discussing ERM, described as follows:

Event identification techniques. An organization's event identification methodology may comprise a combination of techniques and supporting tools ranging from interactive group workshops and process flow analysis to technology-based inventories of potential events. These tools and techniques look to both past trends as well as to the future. Some are industry specific; most are derived from a common approach. They vary widely in level of sophistication and most organizations use a combination of techniques.

Risk assessment techniques. Risk assessment methodologies comprise a combination of qualitative and quantitative techniques. An example of the use of qualitative risk assessment is the use of interviews or group assessment of the likelihood or impact of future events. Quantitative techniques include probablistic and nonprobabilistic models. Probabilistic models are based on certain assumptions about the liklihood of future events. Nonprobabilistic models such as scenario-planning, sensitivity measures, and stress tests, attempt to estimate the impact of events without quantifying an associated likelihood.

Roles and Responsibilities

Everyone in the organization has some role to play in ERM.

Board of directors. Authority for key decisions involving strategic direction, broad-based resource allocation, and setting high-level objectives is reserved for the board. Ensuring that objectives are met, determining that resources are utilized effectively, and acertaining that risks are managed appropriately in the execution of strategy are key functions of the board and its committees.

The board's role in providing oversight of ERM in an organization include the following:

1. Influencing and concurring with the organization's risk philosophy and risk appetite
2. Determining that overall strategy and strategic decisions are in alignment with the organization's risk appetite and philosophy
3. Ascertaining the extent to which management has established effective ERM in the organization
4. Reviewing the organization's portfolio view of risk and considering it in relation to the organization's risk appetite
5. Being apprised of the most significant risks and ascertaining whether management is responding appropriately

Internal audit. If the organization has an internal audit function, its role in ERM is twofold. In addition to identifying and evaluating risk exposures, International Standards for the Professional Practice of Internal Auditing charge the internal audit function with the responsibility for monitoring and evaluating the effectiveness of the organization's risk management system. In this role, internal auditors may support management by providing assurance on the:

- ERM processes—both design and function
- Effectiveness and efficiency of risk responses and related control activities
- Completeness and accuracy of ERM reporting

This responsibility for evaluating the effectiveness of the organization's risk management efforts requires the internal audit function to maintain its independence and objectivity. Accordingly, best practice from a governance perspective would suggest that reporting responsibility for the risk function be a management responsibility that is separate from internal audit.

Limitations of ERM

Effective ERM will provide reasonable assurance to management and the board of directors regarding the achievement of an organization's objectives. However, achievement of objectives is affected by limitations inherent in any management process and the inherent uncertainty of all human endeavor.

The role and reality of human judgement in all aspects of management, including the selection of appropriate objectives, the inevitibility of some degree of failure or error, and the possibility of collusion or management, override of the process are all limiting factors. Another important limitation that must be considered is the cost of various risk response alternatives in relation to their projected benefits.

Conclusion

This primer should have given you a sense of what is meant by ERM and what the responsibilities of a board of directors and audit committee are with respect to risk management within an organization.

Whereas some risk management practices and techniques are complex and sophisticated, the overall concept of ERM is not. Essentially, COSO ERM is a robust comprehensive framework that organizations, management, and boards can use to effectively manage risks and opportunities in line with strategic choices.

Much of what is encompassed in ERM are board and management responsibilities that have previously been carried out intuitively or in a manner less comprehensive and systematic than is comtemplated by an enterprise approach.

All organizations from small single unit organizations to large multinationals face myriad risks and opportunities in a rapidly changing world. Whether large or small, local or global, a more explicit, enterprise approach to risk management can help an organization maximize its opportunities while avoiding unnecessary pitfalls or surprises.

Enterprise Risk Management—The COSO Framework: A Tool for Strategic Oversight

The following tool, "Enterprise Risk Management—The COSO Framework: A Tool for Strategic Oversight," contains questions modeled on the framework in the COSO report, *Enterprise Risk Management—Integrated Framework*.

Enterprise Risk Management—The COSO Framework: A Tool for Strategic Oversight

PURPOSE OF THIS TOOL: This tool is created around the eight interrelated components of the COSO ERM Framework.* Refer to " Enterprise Risk Management—The COSO Framework: A Primer and Tool for the Audit Committee" for a discussion of the components.

When each of the eight components is determined to be effective in each of the four categories of objectives, the board of directors and management have reasonable assurance that they understand the extent to which the organization's strategic and operations objectives are being achieved and that the organization's reporting is reliable and that applicable laws and regulations are being complied with.

INSTRUCTIONS FOR USING THIS TOOL: Within each section is a series of questions that the audit committee should focus on to assure itself that each of the components of the enterprise risk management is present and functioning properly.

These questions should be discussed in an open forum with the individuals that have a basis for responding to the questions. The audit committee should ask for detailed answers and examples from management team, including key line and staff managers as well as members of the financial management, risk management, and internal audit teams to assure itself that the enterprise risk management function is operating as management represents.

Evaluation of the risk management process is not a one-time event, but rather a continuous activity for the audit committee—the audit committee should always be alert for potential deficiencies, and should continually probe the responsible parties regarding risks and opportunities. These questions are written in a manner such that a "No" response indicates a weakness that must be addressed.

* The questions in this tool are adapted from the Committee of Sponsoring Organizations of the Treadway Commission's (COSO's) *Enterprise Risk Management—Integrated Framework* (product code no. 990015), published September 2004, by COSO. It may be purchased through the AICPA store at www.cpa2biz.com. The proceeds from the sale of the framework are used to support the continuing work of COSO.

COSO Framework	Yes	No	Not Sure	Comments
Internal Environment				
1. Are the audit committee's responsibilities for strategic oversight of risk assessment and risk management defined in its charter?	☐	☐	☐	
2. Is the organization's philosophy for managing risk articulated in a comprehensive code of conduct and/or other policies addressing acceptable practices and expected behavior?	☐	☐	☐	
3. Is the risk appetite for the organization formally articulated in qualitative and/or quantitative terms?	☐	☐	☐	
4. Is the risk appetite consistent with the stated risk management philosophy and aligned with the organization's strategy?	☐	☐	☐	
5. Is the risk management approach of the organization consistent with the strategy, structure, and delegation of authority and responsibility in the organization (that is, is the approach to risk assessment and response and the resulting portfolio view appropriate in the context of these dimensions)?	☐	☐	☐	
Objective Setting				
1. Has the board established high-level objectives that are consistent with the strategic direction, key strategic options, and risk appetite for the organization?	☐	☐	☐	
2. Has the board identified critical success factors, relevant performance measures, milestones, and risk tolerances for the achievement of the organization's strategic objectives?	☐	☐	☐	
3. Has the board identified breakpoints and/or risk tolerances that will trigger board discussion of potential need for intervention or modification of strategy?	☐	☐	☐	

(continued)

COSO Framework	Yes	No	Not Sure	Comments
Objective Setting (cont.)				
4. Has management established operations, reporting, and compliance objectives that are aligned with the overall strategic objectives?	☐	☐	☐	
5. Does the board have a relevant and timely progress reporting mechanism in place to monitor implementation of the strategy consistent with the risk philosophy and within the established risk appetite for the organization?	☐	☐	☐	
Event Identification				
1. Has management employed a systematic approach in the identification of potential events that could affect the organization?	☐	☐	☐	
2. Is the categorization of events across the organization, vertically through operating units, by type, by objective, and so on, appropriate to the organization and consistent with the risk philosophy and appetite of the organization?	☐	☐	☐	
Risk Assessment				
1. Has management conducted a systematic assessment of the likelihood and impact of all events with the potential for significant impact on the organization?	☐	☐	☐	
2. Has management sufficiently considered the interdependency of potentially related events in its event identification and risk assessment process?	☐	☐	☐	
Risk Response				
1. Has management adopted an appropriate and cost effective array of risk responses at the activity level of the organization to reduce inherent risks to levels in line with established risk tolerances?	☐	☐	☐	

COSO Framework	Yes	No	Not Sure	Comments
Risk Response (cont.)				
2. Has management taken a portfolio view to assure that the selected risk responses have reduced the organization's overall residual risk to a level within the identified risk appetite for the organization?	☐	☐	☐	
3. If the residual risk level at the organization level is below the organization's risk appetite, has management provided incentives in appropriate target areas to enhance the organization's overall performance?	☐	☐	☐	
Control Activities				
1. Has management implemented adequate control activities throughout the organization to assure that its risk responses are carried out properly and in a timely manner?	☐	☐	☐	
Information and Communication				
1. Do the organization's management information systems capture and provide reliable, timely, and relevant information sufficient to support effective enterprise risk management?	☐	☐	☐	
2. Have adequate communication vehicles been implemented to assure that relevant risk related information is communicated by front-line employees upward in the organization and across its units or processes?	☐	☐	☐	
Monitoring				
1. Are sufficient ongoing monitoring activities built into the organization's operating activities and performed on a real-time basis to allow for appropriate reaction to dynamically changing risk conditions?	☐	☐	☐	

(continued)

COSO Framework	Yes	No	Not Sure	Comments
Monitoring (cont.)				
2. Has evaluation of the enterprise risk management process, either in its entirety, or specific aspects, been given adequate consideration in the scope of the monitoring activities including internal audit work, if applicable?	☐	☐	☐	
3. Have all deficiencies in risk management processes identified as a result of ongiubg monitoring activities, or by the internal audit work, been communicated to the appropriate levels of management and/or the board?	☐	☐	☐	
4. Have all deficiencies and recommendations for improvement in risk management processes been addressed and appropriate corrective actions taken?	☐	☐	☐	

Conducting an Audit Committee Executive Session: Guidelines and Questions

PURPOSE OF THIS TOOL: Although it is generally accepted that audit committees should hold executive sessions with various members of executive management, leaders of the financial management team, the leader of the internal audit team, and the external auditor, audit committee members may not realize the type of questions and the extent of the questions they should ask. This tool is intended to help the audit committee ask the right “first” questions, bearing in mind that the audit committee should have the necessary expertise to evaluate the answers and the insight to identify the appropriate follow-up questions. See the “Other Questions for Management” section of this tool for possible follow-up questions audit committee members can ask key members of the financial management team to improve their understanding of the day-to-day operating environment and management teams’ decision-making processes and interactions.

What is an Executive Session?

An executive session provides the opportunity to ask questions of various members of the management team and the external auditors in a safe environment. By their nature, the questions asked in an executive session are ones that the participants may not feel comfortable answering honestly in an open meeting. During an executive session meeting, minutes (usually) are not recorded. When meeting with members of the financial management team, anyone who is not a member of the audit committee is excluded from the meeting. Executive sessions should occur at every meeting of the audit committee, though some sessions may not require the presence of everyone identified in this document. For example, it may be appropriate for the chief audit executive or his or her equivalent to have an executive session at every meeting. But the director of financial reporting might be in executive session with the audit committee only at the meeting before the audit is accepted. The length of these sessions will vary depending on the issues that need to be discussed by the committee.

It is recommended that executive sessions be conducted with key members of the financial management team and external auditors on an individual basis. It is important that, when meeting with the controller, for example, the CFO not be in the room. Executive sessions should be a routine matter at every audit committee meeting, rather than on an exception basis. The audit committee should avoid asking in an open session whether an individual has anything to discuss in an executive session. That question alone could put the individual in an awkward position with others in the organization.

Asking open-ended questions in an executive session should generate useful information for the audit committee. This tool includes examples of the kinds of questions the audit committee should ask. These are meant to be sample questions to help start a conversation and create dialogue between the individual and the audit committee. These sample questions are not intended to be a checklist. Audit committee members need to have sufficient financial expertise to understand the answers to the questions and to use these answers to develop appropriate follow-up questions. Because it will not be unusual to ask similar questions of key executives, the external auditor, and the internal auditor, a comparison of their responses could be a good source of insight. Depending on the answers, follow-up action also may be necessary, and the audit committee must be prepared to take that action. The most important thing to do when conducting an executive session is to listen to the answers that are given and follow up on anything that is not clear.

Other information that the audit committee wants to know may be beyond that which would be covered in an executive session. Following the suggested executive session questions is an associated section of additional questions, "Other Questions for Management." An executive session may not be required for these questions, which nevertheless may elicit information the audit committee wants.

Audit committee members also should consider the history of the organization, the environment in which it operates, the current economic climate, the competitive environment, and other factors, when asking questions in executive session. Finally, each executive session should be concluded with a reminder to the member of management, that audit committee members are accessible even outside the meeting. The individual should be advised to reach out to the audit committee member at other times if the need arises.

It is important to note that not every organization will have different individuals in each position, as assumed in the following questions. Nevertheless, the audit committee should be aware of the functions that are part of dual roles, and adjust the questions accordingly. For example, in a small organization, the CFO and controller might share the duties of the director of financial reporting.

The audit committee should explore how a function or role is accomplished, and compose questions accordingly. Also, the audit committee should consider and take into account other roles in the organization. It may be that other people within an organization also should be asked to meet with the audit committee in executive session.

INSTRUCTIONS FOR USING THIS TOOL: This tool is intended to help audit committees ask the right "first" questions, bearing in mind that the audit committee should have the necessary expertise to evaluate the answers and the insight to identify the appropriate follow-up questions. Audit committee members may want to use the questions in the "Other Questions for Management" section in conjunction with this one to formulate and ask the appropriate follow-up questions. As a reminder, not every organization will have different individuals in each position, as assumed in the following questions. Nevertheless, the audit committee should be aware of the functions that are part of such dual roles, and adjust the questions accordingly. The first list of suggested questions is applicable to all positions, followed by position-specific questions.

Conducting an Executive Session—Sample Questions	Comments
All Positions	
1. Are you satisfied that an appropriate audit was performed by the external auditors?	
2. Are you aware of any situations of revenue or expense manipulation in the organization?	
3. Are you aware of any current or past occurrences of any kind of fraud in the organization?	
4. Do you know of any situations in which fraud could occur?	
5. Is there any activity at the executive level of management that you consider to be a violation of laws, regulations, generally accepted accounting principles (GAAP), generally accepted government auditing standards (GAGAS), professional, or accepted business practices?	
6. Have you encountered any situations in which the organization complied with legal minimums of behavior, yet failed to demonstrate its commitment to the highest ethical standards?	
7. Are you aware of any disagreements between management of the organization and the external auditors? If any, please provide details of the disagreement.	
8. Is there any activity in the organization that you are uncomfortable with or consider unusual, or that warrants further investigation?	

(continued)

Conducting an Executive Session—Sample Questions	Comments
All Positions (cont.)	
9. Do you feel comfortable raising issues without fear of retribution?	
10. Are there any questions we have *not* asked that should have been asked? If so, what are those questions?	
CFO	
1. Do you believe the financial statements and applicable federal and state tax filings fairly present the organization's financial position and activities?	
2. Do you believe the disclosures are appropriate and complete and are understandable by the average reader?	
3. Describe your working relationship with the CEO.	
4. Describe your relationship with the chief audit executive (CAE). Discuss your impressions of his or her performance.	
5. How do you interface with the internal audit function?	
6. Are you aware of any disagreements between management and the internal auditors? If any, please provide details of the disagreement.	
CEO	
1. Do you believe the financial statements and applicable federal and state tax filings fairly present the organization's financial position?	
2. Do you believe the disclosures are adequate and are understandable by the average reader?	
3. Are you aware of any disagreements between management and the internal auditors? If any, please provide details of the disagreement.	
4. Discuss your impressions of the performance of the CAE, CFO, controller, chief information officer, and General Counsel.	
CAE (leader of Internal Audit Team)	
1. Overall, is management fully cooperating with the internal audit team? Does management have a positive attitude in responding to findings and recommendations, or is it insecure and defensive of findings?	

Conducting an Executive Session—Sample Questions	Comments
CAE (leader of Internal Audit Team) (cont.)	
2. Has management set an appropriate "tone at the top" with respect to the importance of and compliance with the internal control system around financial reporting?	
3. Has management participated or recommended any risk areas and assisted in the development of an audit plan?	
4. Has the organization taken any tax positions that could be construed as overly aggressive?	
5. Do you have the freedom to conduct audits as necessary throughout the organization?	
6. Were you restricted or denied access to requested information?	
7. Have you been pressured to change findings, or minimize the language in those findings so as to not reflect badly on another member of management?	
8. Has the internal audit team cooperated with the external auditor, and shared reports with them?	
9. If you were the CEO, how would you do things differently in the internal audit department?	
10. Are you aware of any whistle-blower activity in the organization?	
11. Are there any disagreements between the internal audit team and management? If any, please provide details of the disagreement.	
Controller	
1. Do you believe the financial statements and applicable federal and state tax filings fairly present the organization's financial position?	
2. Do you believe the disclosures in the financial statements are adequate and are understandable to the average reader?	
3. If you were the CFO, how would you change the financial statements and accompanying footnotes?	
4. Has the organization taken any tax positions that could be construed as overly aggressive?	

(continued)

Conducting an Executive Session—Sample Questions	Comments
Controller (cont.)	
5. Has management set an appropriate tone at the top with respect to the importance of and compliance with the internal control system around financial reporting?	
6. Discuss your impressions of the performance of the CAE.	
7. Are you aware of any whistle-blower activity in the organization?	
8. Are you aware of any conflicts of interest within management?	
Director of Financial Reporting	
1. Do you believe the financial statements and applicable federal and state tax filings fairly present the organization's financial position?	
2. Do you believe the financial statements and related disclosures adequately convey the financial situation in the organization to an average reader?	
3. Now that you have the opportunity, is there anything you want to tell the audit committee? Is there anything else that we need to know?	
General Counsel	
1. Are you aware of any issues that could cause embarrassment to the organization?	
2. Have you ever been told anything in confidence or otherwise that would embarrass the organization if it were known publicly?	
3. Are there any items that have significant financial statement impact that you have discussed with the CEO, CFO or other officers, or outside counsel, that the audit committee should be aware of?	
4. Discuss your impressions of the performance of the CAE.	
5. Has management set an appropriate tone at the top with respect to the importance of and compliance with the internal control system around financial reporting?	
6. Are there any items that have financial statement impact that you have discussed with the CEO, CFO, or other officers, or outside counsel, that the audit committee should be aware of?	

Conducting an Executive Session—Sample Questions	Comments
General Counsel (cont.)	
7. Describe your relationship with the CFO and other key people in the accounting and finance departments.	
External Auditor	
Note that certain communications are required between the external auditor and the audit committee. A separate tool, “Discussions to Expect From the External Auditors,” has been prepared for the audit committee to ensure completeness of the committee’s required communication with the external auditor. These suggested questions are meant to be in addition to the required communications.	
1. Explain the process your firm goes through to ensure that all of your engagement personnel are independent and objective with respect to our audit. Particularly, with respect to nonaudit services, how do those services affect the work that you do or the manner in which the engagement team or others are compensated? Are you aware of any anticipated event that could possibly impair the independence, in fact or in appearance, of the firm and any member of the engagement team?	
2. Has management, legal counsel, or others made you aware of anything that could be considered a violation of laws, regulations, GAAP, GAGAS, professional practice, or the ethics of business?	
3. Are there any areas of the financial statements and the notes that you believe could be more explicit or transparent, or provide more clarity to help a user better understand our financial statements?	
4. Have you expressed any concerns or comments to management with respect to how our financial statement presentation could be improved?	
5. Which accounting policies or significant business transactions do you think a reader will have trouble understanding based on our disclosure? What additional information could (should) we provide?	
6. Based on your auditing procedures, do you have any concerns about how management may be recording revenues and expenses? Have you noticed any biases as a result of your audit tests with respect to estimates?	
7. Are there areas in which you and management have disagreed?	
8. Discuss your impressions of the performance of the CAE in terms of the completeness, accuracy, and faithfulness of the financial reporting process.	

(continued)

Conducting an Executive Session—Sample Questions	Comments
External Auditor (cont.)	
9. Has the firm been engaged to provide any services besides the independent audit and preparation of applicable federal and state tax filings of which the audit committee should be aware?	
10. How can management improve in terms of setting an appropriate tone at the top?	
11. Describe the ideas you have discussed with management for improving the internal control system over financial reporting.	
12. Describe any situation in which you believe management has attempted to circumvent the spirit of GAAP, yet has complied with GAAP.	
13. Was any audit work not performed due to any limitations placed on you by management (for example, any areas scoped out by management or any restriction on fees that limited the scope of your work)?	
14. What, if any, changes do you believe need to be made in these areas?	
15. Is there anything going on in the organization that you are uncomfortable with or consider unusual, or that warrants further investigation?	
16. Are there any questions we have *not* asked that should have been asked? If so, what are those questions?	

Other Questions for Management

PURPOSE OF THIS SECTION: It is important for the audit committee to have a solid familiarity with the management team because the committee relies heavily on them. In some large organizations, there is an expectation that members of the board will interact with members of management one-on-one on a regular basis. However, such interaction is not always possible. This section lists other questions that the audit committee may wish to address to key members of the financial management team. These questions need not be asked in an executive session, but can be addressed more informally as opportunities arise.

Other Questions for Management	Comments
All Positions	
1. What are the biggest risks facing the organization in the next year? What steps do you think the organization should take to manage those risks?	
2. What are the biggest risks facing the organization over the long term? What measures do you believe the organization should take to manage those risks?	
3. Has the external auditor been engaged for any services other than the annual audit and preparation of applicable federal and state tax filings of which the audit committee should be aware?	
CFO	
1. If you were the partner-in-charge of the audit, what would you do differently?	
2. How frequently do you meet with the lead audit partner? Describe your relationship with him or her.	
3. Are the computer systems upon which you rely integrated, or is manual intervention required to integrate your systems?	
4. Which systems are the most difficult to work with?	
5. Are there any new systems or functionality that you would like to purchase but have delayed due to cost considerations?	
6. What procedures or oversight do you apply to manual journal entries that are proposed during the book-closing process?	

(continued)

Other Questions for Management	Comments
CFO (cont.)	
7. Do the accounting and finance departments of the organization have adequate personnel, both in numbers and quality, to meet all their obligations?	
8. What are the most difficult challenges facing the accounting and finance organization today?	
9. Which departments might benefit the most from additional human resources?	
10. What are the personnel turnover rates in the accounting and finance departments for the last year?	
Chief Audit Executive (leader of Internal Audit function)	
1. What procedures do you apply to the review of manual journal entries made during the book-closing process, and to other entries that could be termed as a management override of the internal control system around financial reporting?	
2. Do you believe you have adequate resources available to you to fulfill the charge of the department? If not, what additional resources are needed?	
3. Did you encounter any disagreements or difficulties between the internal audit team and the external auditors in connection with the recently completed audit of the organization's financial statements? How will you approach the financial statement audit differently next year?	
4. What critical risks are being monitored by the internal audit team on a periodic or regular basis? How do you address the continuous auditing of these critical risks, and is automation and integrated system reporting assisting you in this effort?	
5. Are the computer systems upon which you rely integrated, or is manual intervention required to integrate your systems?	
6. Do you monitor payments to the independent audit firm to ensure that the auditor is only providing services that are related to the audit, or other services that have been preapproved by the audit committee (for example, preparation of the IRS Form 990 or Form 990T or both)?	

Other Questions for Management	Comments
Controller	
1. If you were the partner-in-charge of the audit, what would you do differently?	
2. Are the computer systems upon which you rely integrated, or does it require manual intervention to integrate your systems?	
3. What procedures do you apply to review manual journal entries proposed during the book-closing process, or to other entries that could be termed as a management override of the internal control system around financial reporting?	
Director of Financial Reporting	
1. How could the financial statements and related disclosures be improved?	
2. Are the computer systems upon which you rely integrated, or is manual intervention required to integrate your systems?	
Chief Information Officer	
1. Are you satisfied with the integrity of the information running through the systems in the organization? How could technology improve the integrity of the information?	
2. What exposure is associated with the organization's firewalls?	
3. If you had an unlimited budget, how would you spend money to improve the organization's information architecture?	
4. What do you consider your critical risk areas?	
5. Are manual journal entries identified and approved? Are they brought to the attention of the chief audit executive, or other officer(s) that did not have a hand in creating the journal entries?	
6. Is documentation updated every time there is a change to the internal controls process?	

(continued)

Other Questions for the External Auditor	Comments
1. What role, if any, did your firm have in management's documentation and assessment of the organization's internal control structure?	
2. What audit procedures do you apply to manual journal entries that are proposed during the book- closing process, or to other journal entries that could be termed as a management override of the internal control system around financial reporting?	
3. What are the biggest risks facing the organization in the next year? What steps do you think the organization should take to address those risks?	
4. What are the biggest risks facing the organization over the long term? What measures do you believe the organization should take to address those risks?	
Notes	

Conducting an Audit Committee Self-Evaluation: Guidelines and Questions

PURPOSE OF THIS TOOL: Audit committees should conduct a self-evaluation on an annual basis. This can be accomplished in a number of different evaluation formats and scenarios (through the use of outside evaluators, a 360-degree evaluation format, and other methods). The sample questions included in this tool are suggestions and intended to provide a starting point to evaluating the performance and effectiveness of the audit committee. Follow-up questions are encouraged, and the committee should plan for further action as appropriate.

An audit committee should conduct a comprehensive self-evaluation on an annual basis. The self-evaluation can take different forms, involve a number of participants, and use diverse techniques. Most important, however, the self-evaluation should adopt a straightforward approach that will aid the audit committee in assessing its strengths and weaknesses and lay a foundation for future improvement. Some guidelines in designing the format for self-evaluation would include the following areas of consideration.

1. *Introspection.* Be introspective. Evaluate the audit committee's performance by asking specific questions about the impact it has had on the organization, such as its financial reporting process, the annual audit, the relationship with the external auditor, and members of management. Include the chair of the board in this evaluation session and ask for his or her input as well.
2. *Comprehensive.* Conduct 360-degree evaluations of all audit committee members and the committee chair. A *360-degree evaluation* is one that obtains anonymous feedback from a large group of individuals representing various perspectives. In this setting, each committee member would conduct a self-evaluation and be evaluated by the other committee members, the board chair, chief audit executive, CFO, and CEO, and if appropriate, other senior finance and accounting personnel. There should be thought into how the data will be collected (by someone independent), and the board chair and the audit committee chair should consider the result of the evaluations. Making sure to stay consistent with corporate bylaws, they should decide who, if any, of the members of the committee should be rotated off the committee or whether the chair of the committee should be rotated, or both. The members' attendance record and level of participation should be considered during this process.
3. *Qualifications.* All audit committee require financial expertise. Please refer to the tool regarding financial expertise.

INSTRUCTIONS FOR USING THIS TOOL: The sample questions provided in this tool are only a starting point to evaluate the performance and effectiveness of the audit committee. Before completion, the committee should determine how it can best ensure that responses reflect a forthright exchange of ideas and opinions among audit committee members. The committee should determine how the process should be completed. The following sample questions can be completed anonymously before attending an evaluation discussion meeting or during a session of the committee. Discuss the following questions and include notes and comments if you feel further action is appropriate.

Three quick things to note:

1. Although it is best practice to have an audit committee separate from your finance committee, there may be barriers to achieving that. However, when feasible and practical, you should try to have a separate audit committee.
2. Although the questions below do not signify requirements of an audit committee, they are reflective of the best industry practices for an effective audit committee. In most circumstances, organizations that answered "no" to a particular question should consider additional follow-up as they strive to have an effective committee.
3. Specific requirements for audit committees may vary state by state. Please check your specific state requirements for complete compliance.

Audit Committee Self-Evaluation Tool	Yes	No	Not Sure	Comments
1. Are the members financially literate and has the audit committee determined that it has adequate financial expertise in accordance with its charter? For additional reference, please see the tool "Audit Committee Financial Expertise Considerations" in this toolkit.	☐	☐	☐	
2. Does the audit committee have the appropriate number of members? We would suggest a minimum of three members. The audit committee should not be so large that • its ability to operate efficiently and effectively is reduced. • members' ability to raise issues is hampered.	☐	☐	☐	

Audit Committee Self-Evaluation Tool	Yes	No	Not Sure	Comments
• it is difficult to get a quorum when a time-sensitive issue arises. The audit committee should have a sufficient number of members to ensure needed skill sets and knowledge are represented on the committee. An independent nominating and governance committee or independent directors have responsibility for appointing audit committee members and selecting the chair.				
3. Do all members continue to be independent, as defined by policies applicable to the organization? In addition to meeting the technical definitions of independence, committee members demonstrate their objectivity during meetings, through behaviors such as driving and influencing agendas, rigorous probing of issues, consulting with other parties, and hiring experts, as necessary.	☐	☐	☐	
4. Are differences of opinion on issues resolved to the satisfaction of the committee?	☐	☐	☐	
5. Do the members challenge or defer to the chair as appropriate, or both?	☐	☐	☐	
6. Is the audit committee charter used as a document to guide the committee in its efforts, and to help guide the committee's agenda? The audit committee could use the charter matrix to document compliance with the precepts of the charter.	☐	☐	☐	
7. Does the committee engage outside experts, if and when appropriate? A mechanism should be in place for the committee to engage with outside experts if needed.	☐	☐	☐	

(continued)

Audit Committee Self-Evaluation Tool	Yes	No	Not Sure	Comments
8. Are the organization's financial reporting processes stronger as a result of management's interactions with the audit committee? For example: (*a*) The audit committee understands and agrees with the board on which categories of internal control it oversees. Categories include the following (from the Committee of Sponsoring Organizations of the Treadway Commission [COSO] standards): i. Integrity of financial reporting. ii. Compliance with laws and regulations. iii. Operational efficiency and effectiveness. The committee and the board concur with any changes to the committee's internal control oversight mandate. (*b*) The audit committee understands the current high-risk areas as viewed through an overall enterprise risk management system in the categories of controls it oversees, as well as how management addresses those areas.	☐	☐	☐	
9. Is the committee cognizant of the line between oversight and management, and does it endeavor to respect that line?	☐	☐	☐	
10. When the committee conducts executive sessions, are they done in an effective manner? An effective manner offers a "safe haven" to the individual, while asking tough and necessary questions, evaluating the answers, and pursuing issues that might arise to a satisfactory resolution.	☐	☐	☐	

Audit Committee Self-Evaluation Tool	Yes	No	Not Sure	Comments
11. Do audit committee members participate in some form of continuing education to stay abreast of changes in the financial accounting and reporting, regulatory, and ethics areas?	☐	☐	☐	
12. Does the committee do its part to ensure the objectivity of the internal audit team?	☐	☐	☐	
13. Does the committee provide constructive feedback to the chief audit executive at least annually?	☐	☐	☐	
Follow-Up Questions				
	☐	☐	☐	
	☐	☐	☐	
	☐	☐	☐	
	☐	☐	☐	
	☐	☐	☐	
	☐	☐	☐	
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	☐	☐	☐	
	☐	☐	☐	

(continued)

Audit Committee Self-Evaluation Tool	Comments
Other Self-Evaluation Notes	

PART II: Audit Committee—Management and Organization

Independence and Related Topics: Conflict of Interest, Related Parties, Inurement, and Other Issues

PURPOSE OF THIS TOOL: The purpose of this tool is to provide audit committee and board members with an overview of issues of independence and related topics. These topics must be considered in connection with audit committee membership, board membership, and relationships with external auditors and other parties.

Independence implies one's ability to act with integrity and exercise objectivity and professional skepticism. Therefore, independence in not-for-profit governance is critical to promote ethical behavior and reliable financial reporting. With direct contacts to the management team and the auditing firm, the audit committee is quite possibly in the best position to monitor an organization's compliance with independence standards.

Many groups define and require independence from the auditor, the board, and management (see summary table at the end of this tool). The AICPA's independence standards apply to CPAs in all situations requiring independence. In addition, Government Accountability Office (GAO) standards, which are generally more restrictive, apply to engagements involving federal entities and those organizations receiving federal funds. The GAO standards have been voluntarily adopted by many state and local governments and other entities both domestically and internationally. The IRS and most states also have prohibitions against self-dealing and conflicts of interest that have specific provisions and implications for not-for-profit organizations.

In addition, practices are self-imposed by the board of directors. Many not-for-profit organizations include definitions of *independence*, *ethics*, and *integrity* in their policies and procedures. Others require that the board, staff, or both sign annual Statements of Independence or Conflict of Interest. It is recommended that senior management define, communicate, and exhibit these qualities to set a high standard throughout the organization. A sample conflict of interest policy for a not-for-profit organization is provided as a part of this tool.

AICPA: Auditor Independence

Independence shall be considered impaired by a variety of factors. Generally, CPAs are not independent if they are in a position to influence, make management decisions, provide accounting services, or have financial interests in an organization. A CPA is required to document any possible situations that might impair his or her independence on an engagement, inform his or her CPA firm, and inform the potential client if any such situations may exist.

Auditor independence requirements will be determined by state boards of accountancy; state CPA societies; the GAO, if law, regulation, agreement, policy, or contract requires the member's report to be filed under GAO regulations; the Public Company Accounting Oversight Board; the U.S. Securities and Exchange Commission (SEC), if the member's report will be filed with the SEC; the U.S. Department of Labor (DOL) if the member's report will be filed with the DOL; and any organization that issues or enforces standards of independence that would apply to the member's engagement. Such organizations may have independence requirements or rulings that differ from (for example, may be more restrictive than) those of the AICPA.

GAO Yellow Book: Auditor Independence

The GAO enacts auditor independence requirements under *Government Auditing Standards*. Commonly referred to as the Yellow Book, most recently revised by the GAO in 2007, this guide covers federal entities and those organizations receiving federal funds. Various laws require compliance with the comptroller general's auditing standards in connection with audits of federal entities and funds. Furthermore, many states, local governments, and other entities, both domestically and internationally, have voluntarily adopted these standards.

Although the standard deals with a range of auditor independence issues, the rules most significant for many not-for-profit organizations are those associated with nonaudit, or consulting, services. Auditors have the capability of performing a range of services for their clients. However, in some circumstances, it is not appropriate for them to perform both audit and certain nonaudit services for the same client. In these circumstances, the auditor, their client, or both will have to make a choice about which of these services they will provide.

The focus of the auditor independence standard is to better serve the public interest and to maintain a high degree of integrity, objectivity, and independence for audits of government entities. The standard includes a principle-based approach to addressing this issue, supplemented with certain safeguards. The independence standard for nonaudit services is based on the following two overarching principles:

1. Auditors should not perform management functions or make management decisions.
2. Auditors should not audit their own work or provide nonaudit services in situations in which the nonaudit services involved are significant or material to the subject matter of the audit.

For nonaudit services that do not violate these principles, certain supplemental safeguards have to be met, for example: (1) personnel who perform nonaudit services are precluded from planning, conducting, or reviewing any related audit work; (2) the auditor's work cannot be reduced beyond the level that would be appropriate if the nonaudit work was performed by another unrelated party; and (3) certain documentation and quality assurance requirements must be met.

The standard includes an express prohibition regarding auditors providing certain bookkeeping and recordkeeping services, and limits payroll processing and certain other services, all of which are presently permitted under AICPA auditing standards. At the same time, the standard recognizes that auditors can provide routine advice and answer technical questions without violating these two principles or having to comply with the supplemental safeguards. The standard also provides examples of how certain services are treated under the rules.

IRS: Inurement, Disqualified Persons, Excess Benefit, Excise Tax, Revocation

The IRS has a different set of rules and definitions to promote independence from not-for-profit boards and staff. A fundamental requirement for tax-exempt organizations under Internal Revenue Code (IRC) Sections 501(c)3, 6, 7, 9, 10, 13, or 19, is that they must be organized and operated in a way that no part of their net earnings inure (accrue) to the benefit of any private shareholder or individual.

Inurement. Organizations have lost their exempt status because of private inurement from unreasonable compensation; unreasonable fringe benefits; improper (generally personal) use of an organization's assets; forgiveness of debts owed by insiders; personal expenses being paid by the organization; low-interest or unsecured loans to insiders; unreasonable housing allowances; and other-than-arm's-length fair market value purchases, sales, or property rental between the organization and insiders.

An organization is not prohibited from transacting business with members of its board of directors or paying competitive salaries. Certain guidelines and procedures must exist, however, to ensure that transactions do not unreasonably benefit the insider.

Disqualified persons. A *disqualified person* in any transaction is a person who was in a position to exercise substantial influence over the affairs of the applicable tax-exempt organization at any time during a five-year period ending on the date of the transaction. Persons who hold certain powers, responsibilities, or interests are among those who are in a position to exercise substantial influence over the affairs of the organization. This would include, for example, voting members of the governing body, and persons holding the power of

- presidents, CEOs, or chief operating officers.
- treasurers and CFOs.

A disqualified person also includes certain family members of a disqualified person, and 35 percent-controlled entities of a disqualified person.

Excess benefit. An *excess benefit transaction* is a transaction in which an economic benefit is provided by an applicable tax-exempt organization, directly or indirectly, to or for the use of any disqualified person, and the value of such economic benefit provided by the organization exceeds the value of the consideration (including the performance of services) received for providing such benefit.

Excise tax under Section 4958—Intermediate sanctions. An excise tax equal to 25 percent of the excess benefit is imposed on each excess benefit transaction between an applicable tax-exempt organization and a disqualified person. The disqualified person who benefited from the transaction is liable for the tax. If the 25 percent tax is imposed and the excess benefit transaction is not corrected within the taxable period, an additional excise tax of 200 percent of the excess benefit is imposed. An excise tax equal to 10 percent of the excess benefit, up to $20,000 for a single transaction, can also be imposed on an organization's managers who willfully and knowingly participate in excess benefit transactions.

Revocation. The IRS has indicated that the following four factors will be considered in determining whether to revoke an applicable tax-exempt organization's exemption status when an excess benefit transaction has occurred: repeated excess benefit transactions, size and scope of excess benefit transactions, whether organization implemented safeguards to prevent future recurrences, and whether there was compliance with applicable laws.

Summary of Significant Independence and Conflict of Interest Standards and Requirements

AICPA	• Standards Document: AICPA Code of Professional Conduct (ET) section 100, *Independence, Integrity, and Objectivity* (AICPA, *Professional Standards*, vol. 2). • Sets independence standards that CPAs must adhere to with regards to the type of work performed. • Applies to CPAs in all situations involving an attest client. • Attest: Services requiring independence and assurances from the CPA, such as audits, reviews, and agreed-upon procedures.
Government Accountability Office (GAO; formerly General Accounting Office)	• Standards Document: *Government Auditing Standards* (also known as the Yellow Book). • Sets independence standards for federal entities and those organizations receiving federal funds. Various laws require compliance with the comptroller general's auditing standards in connection with audits of federal entities and funds. Furthermore, many states, local governments, and other entities, both domestically and internationally, have voluntarily adopted these standards. • GAO rules are generally more restrictive than those of the AICPA.
IRS	• Standards Document: Internal Revenue Code (IRC) Section 501c—Defines *inurement, disqualified persons, excess benefits*. See also IRS Form 990 instruction booklet. • IRC Section 4958 Intermediate Sanctions: Violations can result in excise taxes on amount of excess benefits and, in some cases, revocation of exempt status.
State Legislation	• Most states include prohibitions against self-dealing or conflict of interest transactions by management and officers.

Conflict of Interest Policy*

[*Organization Name*]

Policy on Conflicts of Interest
and Disclosure of Certain Interests

This conflict of interest policy is designed to help directors, officers, and employees of the [*Organization Name*] identify situations that present potential conflicts of interest and to provide [*Organization Name*] with a procedure that, if observed, will allow a transaction to be treated as valid and binding even though a director, officer, or employee has or may have a conflict of interest with respect to the transaction. In the event there is an inconsistency between the requirements and procedures prescribed herein and those in federal or state law, the law shall control. All capitalized terms are defined in Part 2 of this policy.

1. **Conflict of Interest Defined.** For purposes of this policy, the following circumstances shall be deemed to create Conflicts of Interest:
   a. Outside Interests.
      i. An Agreement or Transaction between [*Organization Name*] and a Responsible Person or Family Member.
      ii. An Agreement or Transaction between [*Organization Name*] and an entity in which a Responsible Person or Family Member has a Material Financial Interest or of which such person is a director, officer, agent, partner, associate, trustee, personal representative, receiver, guardian, custodian, conservator, or other legal representative.
   b. Outside Activities.
      i. A Responsible Person competing with [*Organization Name*] in the rendering of services or in any other Agreement or Transaction with a third party.
      ii. A Responsible Person's having a Material Financial Interest in; or serving as a director, officer, employee, agent, partner, associate, trustee, personal representative, receiver, guardian, custodian, conservator, or other legal representative of, or consultant to; an entity or individual that competes with [*Organization Name*] in the provision of services or in any other Agreement or Transaction with a third party.
   c. Gifts, Gratuities and Entertainment. A Responsible Person accepting gifts, entertainment, or other favors from any individual or entity that:
      i. does or is seeking to do business with, or is a competitor of [*Organization Name*]; or
      ii. has received, is receiving, or is seeking to receive a loan or grant, or to secure other financial commitments from [*Organization Name*];
      iii. is a charitable organization;

* This example of a conflict of interest policy, with key definitions included, was adapted with permission from the Minnesota Charities Review Council.

iv. under circumstances where it might be inferred that such action was intended to influence or possibly would influence the Responsible Person in the performance of his or her duties. This does not preclude the acceptance of items of nominal or insignificant value or entertainment of nominal or insignificant value that are not related to any particular transaction or activity of [*Organization Name*].

2. **Definitions.**

   a. A "Conflict of Interest" is any circumstance described in Part 1 of this Policy.

   b. A "Responsible Person" is any person serving as an officer, employee, or member of the board of directors of [*Organization Name*].

   c. A "Family Member" is a spouse, domestic partner, parent, child, or spouse of a child, brother, sister, or spouse of a brother or sister, of a Responsible Person.

   d. A "Material Financial Interest" in an entity is a financial interest of any kind that, in view of all the circumstances, is substantial enough that it would, or reasonably could, affect a Responsible Person's or Family Member's judgment with respect to transactions to which the entity is a party. This includes all forms of compensation. (The board may wish to establish an amount that it would consider to be a "material financial interest.")

   e. An "Agreement or Transaction" is any agreement or relationship involving the sale or purchase of goods, services, or rights of any kind, the providing or receipt of a loan or grant, or the establishment of any other type of pecuniary relationship by [*Organization Name*]. The making of a gift to [*Organization Name*] is not an Agreement or Transaction within the meaning of this document.

3. **Procedures.**

   a. Before board or committee action on and Agreement or Transaction involving a Conflict of Interest, a director or committee member having a Conflict of Interest and who is in attendance at the meeting shall disclose all facts material to the Conflict of Interest. Such disclosure shall be reflected in the minutes of the meeting.

   b. A director or committee member who plans not to attend a meeting at which he or she has reason to believe that the board or committee will act on a matter in which the person has a Conflict of Interest shall disclose to the chair of the meeting all facts material to the Conflict of Interest. The chair shall report the disclosure at the meeting and the disclosure shall be reflected in the minutes of the meeting.

   c. A person who has a Conflict of Interest shall not participate in or be permitted to hear the board's or committee's discussion of the matter except to disclose material facts and to respond to questions. Such person shall not attempt to exert his or her personal influence with respect to the matter, either at or outside the meeting.

   d. A person who has a Conflict of Interest with respect to an Agreement or Transaction that will be voted on at a meeting shall not be counted in determining the presence of a quorum for purposes of the vote. The person having a conflict of interest may not vote on the Agreement or Transaction and shall not be present in the meeting room when the vote is taken, unless the vote is by secret ballot. Such person's ineligibility to vote shall be reflected in the minutes of the meeting. For purposes of this paragraph, a member of the board of directors of [*Organization Name*] has a Conflict of Interest when he or she stands for election as an officer or for re-election as a member of the board of directors.

e. Responsible Persons who are not members of the board of directors of [*Organization Name*], or who have a Conflict of Interest with respect to an Agreement or Transaction that is not the subject of board or committee action, shall disclose to the Chair or the Chair's designee any Conflict of Interest that such Responsible Person has with respect to an Agreement or Transaction. Such disclosure shall be made as soon as the Conflict of Interest is known to the Responsible Person. The Responsible Person shall refrain from any action that may affect [*Organization Name*]'s participation in such Agreement or Transaction.

   In the event it is not entirely clear that a Conflict of Interest exists, the individual with the potential conflict shall disclose the circumstances to the Chair or the Chair's designee, who shall determine whether there exists a Conflict of Interest that is subject to this policy.

4. **Confidentiality.** Each Responsible Person shall exercise care not to disclose confidential information acquired in connection with such status or information the disclosure of which might be adverse to the interests of [*Organization Name*]. Furthermore, a Responsible Person shall not disclose or use information relating to the business of [*Organization Name*] for the personal profit or advantage of the Responsible Person or a Family Member or the Responsible Person's company.

5. **Review of Policy.**

   a. Each new Responsible Person shall be required to review a copy of this Policy and to acknowledge in writing that he or she has done so.

   b. Each Responsible Person shall annually complete a disclosure form identifying any relationships, positions, or circumstances in which the Responsible Person is involved that he or she believes could contribute to a Conflict of Interest arising. Such relationships, positions, or circumstances might include service as a director of or consultant to a not-for-profit organization, or ownership of a business that might provide goods or services to [*Organization Name*]. Each Responsible Person should also disclose to the board of directors any potential Conflict of Interest that may arise during the course of the year between the submission of annual disclosure forms. Any such information regarding business interests of a Responsible Person or a Family Member shall be treated as confidential and shall generally be made available only to the Chair, the Executive Director, and any committee appointed to address Conflicts of Interest, except to the extent additional disclosure is necessary in connection with the implementation of this Policy.

   c. This policy shall be reviewed annually by each member of the board of directors. Any changes to the policy shall be communicated immediately to all Responsible Persons.

[*Organization Name*]

Conflict of Interest Information Form

Name:______________________________ Date:______________________________

Please describe below any relationships, positions, or circumstances in which you are involved that you believe could contribute to a Conflict of Interest (as defined in [*Organization Name*]'s Policy on Conflicts of Interest) arising.

*I hereby certify that the information set forth above is true and complete to the best of my knowledge. I have reviewed, and agree to abide by, the Policy of Conflict of Interest of [*Organization Name*] that is currently in effect.*

Signature: __________________________________ Date: __________________________________

Sample Document Retention and Destruction Policy

PURPOSE OF THIS TOOL: Certain federal laws prohibit the destruction of certain documents. Not-for-profit organizations should have a written, mandatory document retention and periodic destruction policy. Policies such as this will eliminate accidental or innocent destruction. In addition, it is important for administrative personnel to know the length of time records should be retained to be in compliance.

Document Destruction

The Document Retention and Destruction Policy identifies the record retention responsibilities of staff, volunteers, members of the board of directors, and outsiders for maintaining and documenting the storage and destruction of the organization's documents and records.

The organization's staff, volunteers, members of the board of directors, committee members and outsiders (independent contractors via agreements with them) are required to honor the following rules:

a. Paper or electronic documents indicated under the terms for retention in the following section will be transferred and maintained by (fill in the blank based on the organization's practices);

b. All other paper documents will be destroyed after three years;

c. All other electronic documents will be deleted from all individual computers, data bases, networks, and back-up storage after one year;

d. No paper or electronic documents will be destroyed or deleted if pertinent to any ongoing or anticipated government investigation or proceeding or private litigation (check with legal counsel or the human resources department for any current or foreseen litigation if employees have not been notified); and

e. No paper or electronic documents will be destroyed or deleted as required to comply with government auditing standards (Single Audit Act).

Record Retention

The following table* indicates the minimum requirements and is provided as guidance to customize in determining your organization's document retention policy. Because statutes of limitations and state and government agency requirements vary from state to state, each organization should carefully consider its requirements and consult with legal counsel before adopting a Document Retention and Destruction Policy. In addition, federal awards and other government grants may provide for a longer period than is required by other statutory requirements.

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* Adapted from National Council of Nonprofits.

Type of Document	Minimum Requirement
Accounts payable ledgers and schedules	7 years
Audit reports	Permanently
Bank reconciliations	2 years
Bank statements	3 years
Checks (for important payments and purchases)	Permanently
Contracts, mortgages, notes, and leases (expired)	7 years
Contracts (still in effect)	Contract period
Correspondence (general)	2 years
Correspondence (legal and important matters)	Permanently
Correspondence (with customers and vendors)	2 years
Deeds, mortgages, and bills of sale	Permanently
Depreciation schedules	Permanently
Duplicate deposit slips	2 years
Employment applications	3 years
Expense analyses/expense distribution schedules	7 years
Year-end financial statements	Permanently
Insurance records, current accident reports, claims, policies, and so on (active and expired)	Permanently
Internal audit reports	3 years
Inventory records for products, materials, and supplies	3 years
Invoices (to customers, from vendors)	7 years
Minute books, bylaws, and charter	Permanently
Patents and related papers	Permanently
Payroll records and summaries	7 years
Personnel files (terminated employees)	7 years
Retirement and pension records	Permanently
Tax returns and worksheets	Permanently
Timesheets	7 years
Trademark registrations and copyrights	Permanently
Withholding tax statements	7 years

Resources

- National Council of Nonprofits www.councilofnonprofits.org
- BoardSource Record Retention and Document Destruction Policy—Download 4 Samples (E-Policy Sampler) www.boardsource.org/Bookstore.asp?Type=epolicy&Item=1071
- Independent Sector www.independentsector.org/issues/sarbanesoxley.html
- AICPA Management of an Accounting Handbook—2003 and IRS Appendix Document www.cpa2biz.com/AST/Main/CPA2BIZ_Primary/PracticeManagement/PracticeAdministration/PRDOVR~PC-090407/PC-090407.jsp
- Guide to Record Retention Requirements in the Code of Federal Regulations: Contact the Superintendent of Documents, U.S. Government Printing Office, Washington, D.C. 20402-9325 or from CCH, Inc. at www.onlinestore.cch.com

Unique Transactions and Financial Relationships

PURPOSE OF THIS TOOL: Some transactions and financial relationships put an organization at increased financial risk. In not-for-profit organizations, these transactions often present significant "related party" considerations that should be evaluated and reviewed by the audit committee and possibly reported under the expanded IRS Form 990 requirements. Generally accepted accounting principles provide guidance about how an organization should account for and report these transactions and relationships as a means to fully inform the organization's constituents. It is important that the audit committee understand the nature and the reason for these transactions and relationships, and ensure that management adequately discloses them in the organization's financial statements. This tool is intended to assist audit committee members in gaining an understanding of these unique transactions and relationships so they may assess the appropriateness of management's accounting treatment for them and whether it meets the objectives of financial reporting.

Some transactions and financial arrangements put an organization at increased financial risk. The audit committee should be aware of these transactions, relationships, and circumstances that may require recognition in the organization's financial statements and should ensure that those transactions and events have been accounted for properly. The following are some of the more common of these transactions and relationships that the audit committee should be aware of:

1. Tax-exempt financing
2. Investments in derivative financial instruments
3. Securities lending transactions
4. Relationships with legally separate entities
5. Joint ventures with other governments or organizations
6. Significant contributions or services provided by or contracts with directors

The following information provides background about these types of transactions and relationships.

Tax-Exempt Financing

Many not-for-profit organizations enjoy the benefit of tax-advantaged borrowing through the use of tax-exempt bonds. In the typical tax-exempt bond transaction, a conduit governmental agency issues bonds carrying interest rates below those of taxable bonds on behalf of the not-for-profit organization. Upon issuance, the bonds are purchased by an underwriter and sold to institutional investors, the general public, or both. The conduit agency simultaneously lends the proceeds to the not-for-profit organization at repayment terms specified in the loan agreement and the bond indenture. Some tax-exempt bonds are issued with credit enhancement, giving the investors in such bonds assurance regarding their credit worthiness. Not-for-profit organizations use credit enhancement to lower the overall cost of borrowing. Such enhancement may be employed in the form of bond insurance or a letter of credit from a highly rated financial institution. In such cases the provider of credit enhancement usually requires certain fees, financial covenants, collateral, or any combination of such, from the not-for-profit organization in return for providing the enhancement.

To assure success, the typical tax-exempt bond transaction involves the services of many experts. For example, the not-for-profit organization should employ the services of competent borrower's counsel having an excellent track record in transactions similar to the proposed deal. The not-for-profit organization will also need a highly experienced underwriter to help structure the deal, guide the process, and eventually sell the bonds. Often, a not-for-profit organization borrower will engage a financial consultant to assist in developing financial pro-formas. In consultation with the conduit governmental issuer, the not-for-profit organization will select the bond counsel, whose role is to protect the interests of bondholders and certify the bonds as tax exempt. If credit enhancement is part of the plan, the not-for-profit organization will select an appropriate provider and negotiate the best possible credit deal. In addition, the conduit issuer and the credit enhancement provider will be represented by legal counsel. The fees for all these professionals are normally paid by the not-for-profit organization borrower and become part of the bond issuance costs.

Bond issuance costs generally should not exceed 2 percent of the total face amount issued. Additionally, the repayment term for tax-exempt bonds usually cannot exceed the average estimated economic life of the project costs funded by such bonds and proceeds from the tax-exempt financing generally cannot be used to fund costs for which specific resources have been dedicated, such as restricted contributions received from institutional and individual donors.

Many regulatory issues are operative in issuing tax exempt bonds. The audit committee of a not-for-profit organization tax-exempt bond borrower should obtain assurance from management, competent advisors, or both that all applicable laws and regulations have been observed. Specific consideration should be given to:

1. State laws governing issuance and the use of tax-exempt bond proceeds—Although tax-exempt borrowing is allowed by federal law (under certain circumstances), each state must enact enabling legislation to designate conduit issuers and regulate the use of tax-exempt bond proceeds. For example, some states may restrict the use of tax-exempt bond proceeds to housing programs.
2. IRS regulations concerning:
   a. Use of proceeds—IRS regulations include specific qualified uses for tax-exempt bond proceeds. Generally, proceeds must be used primarily for capital projects, with certain exceptions. No more than 2 percent of proceeds may be used to finance issuance costs.
   b. Qualifying borrowers and issuers—Issuance of tax-exempt bonds and use of the proceeds therefrom is restricted to certain types of entities. The IRS is the watchdog agency to ensure that the substantial benefits provided by tax-exempt borrowing accrue only to the intended beneficiaries.
   c. Report filing—At issuance, the not-for-profit organization borrower must file IRS Form 8038, *Information Return for Tax Exempt Private Activity Bond Issues*. In addition, throughout the life of the bonds, the not-for-profit organization borrower must periodically file additional forms with the IRS.
   d. Arbitrage rebate—These regulations are extremely complex, usually requiring the assistance of special experts to ensure compliance. IRS arbitrage rebate regulations ensure that not-for-profit organization borrowers use bond proceeds in a timely manner in compliance with tax regulations.

If a not-for-profit organization borrower earns a profit from investment of tax-exempt bond proceeds in taxable securities and fails to timely use this profit (arbitrage) to pay project costs, IRS arbitrage rebate regulations require the not-for-profit organization to return (or rebate) the excess investment earnings to the U.S. Treasury or face severe penalties.

3. SEC regulations concerning public debt offerings—Such regulations include compliance requirements regarding initial offering statements, the types and quality of information provided to the public and the veracity of statements made concerning the bonds. Additionally, under SEC Rule 15c2-12, issuers of fixed-rate tax-exempt debt are required to make prescribed secondary market disclosures until the bonds are retired.

In short, due to the complexity of tax-exempt bond transactions, it is imperative that an audit committee monitors the organization's compliance with laws and regulations; both for the initial offering and on an ongoing basis after the debt has been issued. The audit committee should review the deal points of a proposed tax-exempt bond transaction well before the anticipated issuance date.

Derivatives

An organization's investment policies may allow investments in financial instruments that are not routine or actively traded in the market. Routine or actively traded financial instruments, such as repurchase agreements, government agency debt securities, and money market funds, have some degree of risk. However, derivatives, which are financial instruments or contracts that have unique characteristics underlying their ultimate investment yield, typically have much greater risk.

When an organization holds derivatives, these financial instruments are included in the amount of investments reported in the organization's financial statements, at the instrument's market value, referred to as its fair value. In many cases the derivative may not be actively traded in the market, or its fair value may be based on complicated, unknown events. For this reason, the notes to the financial statements should discuss the following: the organization's objectives for holding or issuing derivatives, the context needed to understand those objectives, and its strategies for achieving those objectives. In addition to many other details, the disclosure should provide information about the organization's policies related to the various types of derivative instruments and a description of the items or transactions for which risks are hedged.

Financial Accounting Standards Board (FASB) *Accounting Standards Codification* (ASC) 815*, Derivatives and Hedging*, is the source for technical guidance about accounting for derivatives and required reporting disclosures.

Securities Lending Transactions

Sometimes, organizations have large amounts of long-term investments in their portfolios. If an organization wants to earn additional income, it might lend some securities to brokers or financial institutions that need to borrow those securities to cover a short position (that is, they sold a security without owning it) or to avoid a failure to receive a security it purchased for delivery to a buyer. In these transactions, the organization transfers its securities for collateral, which may be cash or other securities, and agrees to return the collateral for its original securities at some time in the future.

When an organization lends its securities, it reports these securities as pledged assets in its financial statements. If the organization receives cash as collateral on the securities lending transactions, makes investments with that cash, or can sell the securities it received as collateral, these amounts are also reported as assets in the financial statements. Of course, because the collateral must be returned in the future, the organization also reports a liability for these transactions in the financial statements. In addition, the notes to the financial statements should disclose:

- The policy for requiring collateral or other security
- The carrying amount and classification of assets not reported separately in the statement of financial position
- The fair value of collateral and the amount sold or repledged as of the statement date in situations in which the transferor has received collateral that it is permitted to sell or repledge.

FASB ASC 860, *Transfers and Servicing*, provides specific guidance on accounting and reporting for securities lending transactions.

Relationship With Legally Separate Entities

Separate entities are created by not-for-profit organizations for a variety of reasons. Some of the more common reasons include greater efficiency in financing and administering debt backed by revenue-generating activities and providing additional services that may not have been envisioned when the organization's charter was written.

Financial reporting standards require an organization to determine when a separate organization should be included as part of the organization's financial reporting organization through consolidation. Although detailed and complex analyses ultimately determine which legally separate entities should be consolidated, entities are generally included if they are controlled by the organization.

AICPA Statement of Position 94-3, *Reporting of Related Entities by Not-for-Profit Organizations* (AICPA, *Technical Practice Aids*, ACC sec. 10,610), provides specific guidance on financial reporting under such circumstances.

Joint Ventures

A *joint venture* is a legal entity that results from a contractual arrangement to pool resources and share the costs, risks, and rewards of an activity with other organizations. In a joint venture, each of the participants retains an ongoing financial interest, an ongoing financial responsibility, or both.

Joint ventures typically are accounted for using the equity method of accounting. Under the equity method, the organization recognizes its respective share of the joint venture's income or loss and any changes in the value of the joint venture.

FASB ASC 323, *Investments—Equity Method and Joint Ventures*, provides specific guidance on financial reporting under such circumstances.

Significant Contributions or Services Provided by or Contracts with Directors

The audit committee should determine the existence of significant related party relationships and transactions with such parties. Transactions with directors of the organization's governing board may have to be disclosed under the Financial Accounting Standards Board *Accounting Standards Codification* 850, *Related Party Disclosures*.

Some states have exhibited a heightened concern about whether the governing board members of not-for-profit organizations are meeting their stewardship responsibilities, particularly if potential conflicts exist between the governing board members' financial interests and their duties as board members.

The organization should have an increased sensitivity when it enters into business relationships with board members and should have appropriate controls for addressing potential conflicts of interest that could arise in related-party transactions and for ensuring that such transactions are disclosed to and approved by the board.

INSTRUCTIONS FOR USING THIS TOOL: The sample questions included in this tool are a starting point for understanding unique transactions and special relationships that may be present in a not-for-profit organization. Audit committee members should answer the following questions in discussion with management and consultation with the external auditor or other experts as needed.

Audit Committee Questions of Management	Notes
Tax-Exempt Bond Offerings	
1. Describe the proposed tax-exempt bond transaction deal points, including use of funds, bond structure, interest rate mode, credit enhancement, covenants, collateral, repayment terms, and source of repayment funds, for example.	
2. Describe the process for selection and qualifications of expert advisors engaged to assist with the tax-exempt bond transaction: • Borrower's counsel • Financial consultant underwriter • Bond counsel • Credit enhancement provider • Arbitrage rebate compliance consultant • Bond trustee	
3. Describe the procedures management will implement to ensure compliance with state and federal laws and IRS and Securities and Exchange Commission (SEC) regulations governing tax-exempt bond transactions. Specifically, how will management protect the organization from the risk of noncompliance default?	
4. Describe management's proposed accounting treatment of issuance costs and review tax-exempt bond footnote disclosure in the financial statements.	
5. Review the initial offering statement. Discuss compliance with SEC regulations including Rule 15c2-12 disclosures, if applicable.	
6. Review IRS Form 8038, Information Return for Tax Exempt Private Activity Bond Issues. Discuss ongoing compliance with IRS regulations with respect to arbitrage rebate rules.	

Audit Committee Questions of Management	Notes
Tax-Exempt Bond Offerings (cont.)	
7. Describe all debt covenants resulting from the tax-exempt bond transaction and procedures to ensure compliance on an ongoing basis. Review financial statement footnote disclosure of material debt covenants.	
Derivatives	
1. Describe the organization's policies for investing in derivative financial instruments. Are there any restrictions regarding the type, maturity length, or percentage of total portfolio?	
2. Describe how management has valued its derivatives for financial statement presentation. Discuss the types of risks these investments have and how management has decided to manage those risks.	
Securities Lending	
1. Describe the organization's policies for entering into securities lending agreements.	
2. Describe how any securities lending transactions have been accounted for and whether they have been included in the organization's financial statements. Include whether collateral can be used to purchase securities, whether maturities of original and collateral securities match, and the credit risk associated with the securities.	
Legally Separate Entities	
1. Has the organization created, authorized, or become aware of any legally separate organizations that have financial relationships with the organization? If so, provide details of the arrangement.	
Joint Ventures	
1. Has the organization entered into any agreement with another organization to share resources, costs, and risks for providing goods and services or other purposes? If so, describe the details of the arrangement.	

(continued)

Audit Committee Questions of Management	Notes
Joint Ventures (cont.)	
2. For any such agreements, please describe how the organization accounts for its participation and how the effects of such participation are displayed or disclosed in the organization's financial statements.	
Significant Contracts with Directors	
1. Has the organization entered into any contracts or agreements with any board director for providing goods or services to the organization? If so, please describe the details of the arrangement.	
2. For any such agreements, describe how the agreement was disclosed to and approved by the board.	
3. Was the agreement reviewed in connection with the organization's conflict of interest policy, if one exists?	

Significant Issues, Estimates, and Judgments: Management's Report to the Audit Committee

PURPOSE OF THIS TOOL: The audit committee needs to be proactive and consistent in its inquiries regarding significant issues, estimates, and judgments. At each meeting, the audit committee should inquire about current or unresolved issues or problems that have arisen in the financial, compliance, or operational control environment. Management should be encouraged to use this tool as the means to document and communicate these matters for discussion with the audit committee. Each matter should be prepared as a separate report. Statements should be clear and concise. Some items may carry over to subsequent meetings, in which case, any updated information should be included and highlighted.

Identifying Significant Issues, Estimates, and Judgments

As a first step to any discussion of this nature among the audit committee members, it is important for the audit committee to establish the threshold for a significant issue, judgment, or estimate. The following are some points that the audit committee should consider in its quest to identify a significant issue, estimate, or judgment.

A significant issue, estimate, or judgment is one that

1. creates controversy among members of the management team, or between management and the internal or external auditors.
2. has or could have a material impact on the financial statements.
3. is or could be a matter of public interest or exposure.
4. may be reported in an external release of financial information when management is unclear or undecided on its presentation. (This may include the annual report, federal, state, or local filings, funder reports, and any bond filings.)
5. relates to the application of an accounting standard in a way that is not consistent with general practice or represents the application of a new accounting standard. (The application of a new accounting standard may or may not be considered a significant issue, estimate, or judgment for the organization. However, the audit committee may ask management to use this format as the means with which to brief the audit committee on the application of the new standard.)
6. relates to key controls over financial information that are being designed or redesigned, have failed, or otherwise are being addressed by the organization.

The audit committee needs to be proactive and consistent in its inquiries regarding significant issues, estimates, and judgments. At each meeting, the audit committee should inquire about current or unresolved issues or problems that have arisen in the financial, compliance, or operational control environment. The highlights of the discussion and management's response should be documented in the meeting minutes.

Management's report to the audit committee concerning significant issues, estimates, and judgments should contain the following elements to provide a proper basis for discussion by the audit committee:

1. *Identification of the significant issue, estimate, or judgment.* In this section of the report, management should summarize the issue as concisely and clearly as possible.
2. *Management's position.* This section should address management's position on the issue. If a disagreement occurs among members of management, those disagreements should be detailed here as explicitly as possible, with brief explanations of each respective position.
3. *Relevant literature.* Both authoritative and nonauthoritative literature or regulatory requirements addressing this matter should be cited here. If no relevant literature is available, it would be appropriate to reference industry practice in this space. If this is a developing area, and no accepted industry practice or other source exists to support or refute these positions, this fact should be reported. If a choice exists regarding the accounting treatment, that should be disclosed here along with an explanation of how the choices of treatment were compared and the rationale for the treatment selected.
4. *Risks.* Management should discuss various short and long-term risks and opportunities associated with this matter.
5. *Federal or state agency or other regulatory disclosure.* Management must inform the audit committee of how it intends to address this matter in required filings.
6. *Auditor's position.* If management has consulted with the external auditors on this matter, the discussion should be summarized in this section. The discussion should include an indication of whether the external auditors agree with management's position and whether the auditors have addressed the audit issues that might be associated with it. If management has not consulted the external auditors on the matter, this should be indicated in this section.
7. *Other information relating to this issue, estimate, or judgment.* Management should use this section to highlight other related and relevant information that is not already included in the previous sections.

PART III: Audit Committee—Internal Control and Internal Audit

Internal Control: A Tool for the Audit Committee

PURPOSE OF THIS TOOL: Internal control over financial reporting continues to be a major area of importance in the governance of an organization. This tool is intended to give audit committees basic information about internal control to understand what it is, what it is not, how it can be used most effectively in the organization, and the requirements of management with respect to the system of internal control over financial reporting. Note that the primary responsibility of the audit committee with respect to internal control is the system of internal control over financial reporting.

Basics of Internal Control

In 1992, the Committee of Sponsoring Organizations of the Treadway Commission (COSO)[1] published a document called *Internal Control—Integrated Framework*,[2] which defined *internal control* as "a process, effected by an entity's board of directors, management and other personnel, designed to provide reasonable assurance regarding the achievement of objectives" in the following three categories:

1. Effectiveness and efficiency of operations
2. Reliability of financial reporting
3. Compliance with applicable laws and regulations

Internal control can be judged as effective in each of these categories if the board of directors and management have reasonable assurance that

1. they understand the extent to which the organization's operations objectives are being achieved.
2. published financial statements are being prepared reliably.
3. applicable laws and regulations are being complied with.

The COSO framework consists of five interrelated components as follows:

1. *Control environment.* Sometimes referred to as the "tone at the top" of the organization, meaning the integrity, ethical values, and competence of the organization's people; management's philosophy and operating style; the way management assigns authority and responsibility and organizes and develops its people; and the attention and direction provided by the board of directors. It is the foundation for all other components of internal control, providing discipline and structure.
2. *Risk assessment.* The identification and analysis of relevant risks to achieve the objectives that form the basis to determine how risks should be managed. This component should address the risks, both internal and external, that must be assessed. Before conducting a risk assessment, objectives must be set and linked at different levels.

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[1] The Committee of Sponsoring Organizations of the Treadway Commission (COSO) consists of the AICPA, the Institute of Management Accountants, the Institute of Internal Auditors, Financial Executives International, and the American Accounting Association.
[2] The COSO publication *Internal Control—Integrated Framework* (product code no. 990012), may be purchased through the AICPA store at www.cpa2biz.com. The proceeds from the sale of the framework are used to support the continuing work of COSO.

3. *Control activities.* Policies and procedures that help ensure that management directives are carried out. Control activities occur throughout the organization at all levels in all functions. These include activities such as approvals, authorizations, verifications, reconciliations, reviews of operating performance, security of assets, and segregation of duties.
4. *Information and communication.* Addresses the need in the organization to identify, capture, and communicate information to the right people to enable them to carry out their responsibilities. Information systems within the organization are key to this element of internal control. Internal information, as well as external events, activities, and conditions must be communicated to enable management to make informed business decisions and for external reporting purposes.
5. *Monitoring.* The internal control system must be monitored by management and others in the organization. This is the framework element that is associated with the internal audit function in the organization, as well as other means of monitoring such as general management activities and supervisory activities. It is important that internal control deficiencies are reported upstream, and that serious deficiencies are reported to top management and the board of directors.

These five components are linked together, thus forming an integrated system that can react dynamically to changing conditions. The internal control system is intertwined with the organization's operating activities, and is most effective when controls are built into the organization's infrastructure, becoming part of the very essence of the organization.

Key Terms in Internal Control

A few common internal control terms are described as follows:

Significant deficiency. Defined by Statement on Auditing Standards (SAS) No. 115, C*ommunicating Internal Control Related Matters Identified in an Audit* (AICPA, *Professional Standards*, vol. 1. AU sec. 325), a significant deficiency is a deficiency, or a combination of deficiencies, in internal control that is less severe than a material weakness, yet important enough to merit attention by those charged with governance.

Material weakness. Defined by SAS No. 115 as a deficiency, or combination of deficiencies, in internal control, such that there is a reasonable possibility that a material misstatement of the entity's financial statements will not be prevented, or detected and corrected, on a timely basis.

Compensating controls. Some organizations, by virtue of their size, are not able to implement basic controls such as segregation of duties. In these cases, it is important that management institute compensating controls to cover for the lack of a basic control, or if a basic control is not able to function for some period of time.

What Internal Control Cannot Do

As important as an internal control structure is to an organization, an effective system is not a guarantee that the organization will be successful. An effective internal control structure will keep the right people informed about the organization's progress (or lack of progress) in achieving its objectives, but it cannot turn a poor manager into a good one. Internal control cannot ensure success, or even survival.

Internal control is not an absolute assurance to management and the board about the organization's achievement of its objectives. It can only provide reasonable assurance due to limitations inherent in all internal control systems. For example, breakdowns in the internal control structure can occur due to simple error or mistake, as well as faulty judgments that could be made at any level of management. In addition, controls can be circumvented by collusion or by management override. Finally, the design of the internal control system is a function of the resources available, meaning that a cost-benefit analysis must be in the design of the system.

Roles and Responsibilities

Everyone in the organization has some role to play in the organization's internal control system.

CEO/president/executive director. The CEO has ultimate responsibility and "ownership" of the internal control system. The individual in this role sets the tone at the top that affects the integrity and ethics and other factors that create the positive control environment needed for the internal control system to thrive. Aside from setting the tone at the top, much of the day-to-day operation of the control system is delegated to other senior managers in the organization, under the leadership of the CEO.

CFO/vice president of finance/director of finance. Much of the internal control structure flows through the accounting and finance area of the organization under the leadership of the CFO. In particular, controls over financial reporting fall within the domain of the CFO. The audit committee should use interactions with the CFO and others as a basis for their comfort level on the internal control over financial reporting.

This is not intended to suggest that the CFO must provide the audit committee with a level of assurance regarding the system of internal control over financial reporting. Rather, through interactions with the CFO and others, the audit committee should get a gut feeling about the completeness, accuracy, validity, and maintenance of the system of internal control over financial reporting.

Controller/director of accounting or finance. Much of the basics of the control system come under the domain of this position. It is key that the controller understands the need for the internal control system, is committed to the system, and communicates the importance of the system to all people in the accounting organization. Further, the controller must demonstrate respect for the system though his or her actions.

Internal audit. A main role for the internal audit team is to evaluate the effectiveness of the internal control system and contribute to its ongoing effectiveness. With the internal audit team reporting directly to the audit committee of the board of directors or the most senior levels of management, or both, it is often this function that plays a significant role in monitoring the internal control system. It is important to note that many not-for-profits are not large enough to employ an internal audit team. Each organization should assess the need for this team in light of available resources.

Board of directors/audit committee. A strong, active board is necessary. This is particularly important when the organization is controlled by an executive or management team with tight reins over the organization and the people within the organization. The board should recognize that its scope of oversight of the internal control system applies to all the three major areas of control: over operations, over compliance with laws and regulations, and over financial reporting. The audit committee is the board's first line of defense with respect to the system of internal control over financial reporting.

All other personnel. The internal control system is only as effective as the employees throughout the organization that must comply with it. Employees throughout the organization should understand their role in internal control and the importance of supporting the system through their own actions and encouraging respect for the system by their colleagues throughout the organization.

Compensating Controls

It is important to realize that both the design and compliance with the internal control system is important. The audit committee should be tuned-in to the tone at the top of the organization as a first indicator of the functioning of the internal control system.

In addition, audit committees should realize that the system of internal control should be scaled to the organization. Some organizations will be so small, for example, that they will not be able to have appropriate segregation of duties. The message here is that the lack of segregation of duties is not automatically a material weakness, or even a reportable condition, depending on the compensating controls that are in place.

For example, suppose an organization's accounting department is so small that it is not possible to segregate duties between the person who does the accounts payable and the person who reconciles the bank statements. In this case, that person is one and the same, so the implication is that there are no checks and balances on the accounts payable person, who could be writing checks to a personal account, then passing on them during the bank reconciliation process (that is, there is no one to raise the red flag that personal checks are being written on the organization account).

Compensating controls could make up for this apparent breach in the internal control system. The following are some examples of compensating controls in this situation:

1. All checks are hand signed by an officer of the organization, rather than using a signature plate that is in the control of the person that prepared the checks.
2. The bank reconciliation may be reviewed by the preparer's manager.
3. A periodic report of all checks that are cleared at the bank could be prepared by the bank and forwarded to an officer of the organization for review.

Audit committees should be aware of situations like this and be prepared to ask questions and evaluate the answers when an apparent breach in internal control is surfaced.

Management Override of Controls

Another area that an audit committee needs to focus on is the ability of management to override internal controls over financial reporting to perpetrate a fraud. Examples of techniques used by management in overriding internal controls over the financial reporting function include the following:

- Back dating or forward dating documents to a different period
- Making adjusting entries during the financial reporting closing process
- Reclassifying items improperly between the statement of activity and the statement of financial condition

An audit committee has the responsibility to help prevent or deter a management override of controls. It is important for the audit committee to understand that a system exists to uncover an override, as well as follow-up to determine its appropriateness. Questions about management override, and the controls over management override, as well as audit steps to detect if a management override has occurred, should be addressed to the CEO, CFO, and external auditor during the respective executive (in-camera) sessions with the audit committee as noted elsewhere in this toolkit.

Conclusion

This tool was intended to provide a summary of what is meant by *internal control*. The concepts are not complex, but sometimes the application of internal control can be a challenge in an organization, depending on its size and culture. However, it is vitally important to design the system of internal control to achieve the objectives of (1) effectiveness and efficiency of operations, (2) reliability of financial reporting, and (3) compliance with applicable laws and regulations.

Simply stated, a strong system of internal control (both in its design and compliance) is good business.

Internal Control—A Tool for the Audit Committee

The following tool, “Internal Control—A Tool for the Audit Committee,” contains questions modeled on those found in the COSO report, *Internal Control—Integrated Framework*.

Internal Control—A Tool for the Audit Committee

INSTRUCTIONS FOR USING THIS TOOL: This tool is created around the five interrelated components of an internal control structure. Within each component is a series of questions that the audit committee should focus on to assure itself that controls are in place and functioning. These questions should be discussed in an open forum with the individuals who have a basis for responding to the questions. The audit committee should ask for detailed answers and examples from the management team, including key members of the financial management team, internal auditors, and external auditors to assure itself that the system is operating as management represents. Evaluation of the internal control structure is not a one-time, but rather a continuous, activity for the audit committee—the audit committee should always have its eyes and ears open for potential weaknesses in internal control and should continuously probe the responsible parties regarding the operation of the system. These questions are written in a manner such that a "no response" indicates a weakness that must be addressed.

Control Environment—Tone at the Top	Yes	No	Not Sure	Comments
Integrity and Ethical Values				
1. Does the organization have a comprehensive code of conduct or other policies addressing acceptable business practice, conflicts of interest, and expected standards of ethical and moral behavior?	☐	☐	☐	
2. Is the code distributed to all employees?	☐	☐	☐	
3. Are all employees required to annually acknowledge that they have read, understood, and complied with the code?	☐	☐	☐	
4. Does management demonstrate through actions its own commitment to the code of conduct?	☐	☐	☐	
5. Are dealings with clients and other constituents, customers, suppliers, employees, and other parties based on honesty and fair business practices?	☐	☐	☐	
6. Does management take appropriate action in response to violations of the code of conduct?	☐	☐	☐	

Control Environment—Tone at the Top	Yes	No	Not Sure	Comments
Integrity and Ethical Values (cont.)				
7. Is management explicitly prohibited from overriding established controls? What controls are in place to provide reasonable assurance that controls are not overridden by management? Are deviations from this policy investigated and documented? Are violations (if any) and the results of investigations brought to the attention of the audit committee?	☐	☐	☐	
8. Is the organization proactive in reducing fraud opportunities by (1) identifying and measuring fraud risks, (2) taking steps to mitigate identified risks, (3) identifying a position within the organization to “own” the fraud prevention program, and (4) implementing and monitoring appropriate preventative and detective internal controls and other deterrent measures?	☐	☐	☐	
9. Does the organization use an anonymous ethics and fraud hotline and, if so, are procedures in place to investigate and report results to the audit committee? (See also the tool “Sample Whistle-Blower Tracking Report,” in this toolkit.)	☐	☐	☐	
Commitment to Competence				
1. Are the level of competence and the requisite knowledge and skills defined for each job in the accounting and internal audit departments?	☐	☐	☐	
2. Does management make an effort to determine whether the accounting and internal audit departments have adequate knowledge and skills to do their jobs?	☐	☐	☐	

(continued)

Control Environment—Tone at the Top	Yes	No	Not Sure	Comments
Board of Directors and/or Audit Committee				
1. Are the audit committee's responsibilities defined in a charter? If so, is the charter updated annually and approved by the board of directors? (See also the tool "Audit Committee Charter Matrix," in this toolkit.)	☐	☐	☐	
2. Are audit committee members independent of the organization and of management? Do audit committee members have the knowledge, industry experience, and financial expertise to serve effectively in their role?	☐	☐	☐	
3. Are a sufficient number of meetings held, and are the meetings of sufficient length and depth to cover the agenda and provide healthy discussion of issues?	☐	☐	☐	
4. Does the audit committee constructively challenge management's planned decisions, particularly in the area of financial reporting, and probe the evaluation of past results?	☐	☐	☐	
5. Are regular meetings held between the audit committee and the CFO, the chief audit executive (internal audit), other key members of the financial management and reporting team, and the external auditors? Are executive sessions conducted on a regular basis? (See also the tool "Conducting an Audit Committee Executive Session: Guidelines and Questions," in this toolkit.)	☐	☐	☐	
6. Does the audit committee approve internal audit's annual audit plan?	☐	☐	☐	
7. Does the audit committee receive key information from management in sufficient time in advance of meetings to prepare for discussions at the meetings?	☐	☐	☐	

Control Environment—Tone at the Top	Yes	No	Not Sure	Comments
Board of Directors and/or Audit Committee (cont.)				
8. Does a process exist for informing audit committee members about significant issues on a timely basis and in a manner conducive to the audit committee having a full understanding of the issues and their implications? (See also the tool "Significant Issues, Estimates, and Judgments: Management's Report to the Audit Committee" in this toolkit.)	☐	☐	☐	
9. Is the audit committee informed about personnel turnover in key functions including the audit team (both internal and the external auditors), senior executives, and key personnel in the financial accounting and reporting teams? Are unusual employee turnover situations observed for patterns or other indicators of problems?	☐	☐	☐	
Management's Philosophy and Operating Style				
1. Is the accounting department viewed as a team of competent professionals bringing information, order, and controls to decision-making?	☐	☐	☐	
2. Is the selection of accounting practices made in the long-term best interest of the organization (as opposed to short-term benefits)?	☐	☐	☐	
3. Are assets, including intellectual assets, protected from unauthorized access and use?	☐	☐	☐	
4. Do managers respond appropriately to unfavorable signals and reports?	☐	☐	☐	
5. Are estimates and budgets reasonable and achievable?	☐	☐	☐	

(continued)

Control Environment—Tone at the Top	Yes	No	Not Sure	Comments
Organizational Structure				
1. Is the organizational structure within the accounting function and the internal audit function appropriate for the size of the organization?	☐	☐	☐	
2. Are key managers in the accounting and internal audit functions given adequate definition of their responsibilities?	☐	☐	☐	
3. Do sufficient numbers of employees exist, particularly at the management levels in the accounting and internal audit functions, to allow those individuals to effectively carry out their responsibilities?	☐	☐	☐	
Assignment of Authority and Responsibility				
1. Is the authority delegated appropriate for the responsibilities assigned?	☐	☐	☐	
2. Are job descriptions in place for management and supervisory personnel in the accounting and internal audit functions?	☐	☐	☐	
3. Do senior managers get involved as needed to provide direction, address issues, correct problems, and implement improvements?	☐	☐	☐	
Human Resources Policies and Practices				
1. Are policies and procedures in place for hiring, training, promoting, and compensating employees in the accounting and internal audit functions?	☐	☐	☐	
2. Do employees understand that sub-standard performance will result in remedial action?	☐	☐	☐	
3. Is remedial or corrective action taken in response to departures from approved policies?	☐	☐	☐	
4. Do employees understand the performance criteria necessary for promotions and salary increases?	☐	☐	☐	

Control Environment—Tone at the Top	Yes	No	Not Sure	Comments
Risk Assessment				
1. Has the organization conducted a systematic assessment of the risk of failure in its internal control environment and identified the likely areas of weakness? (See the "Enterprise Risk Management—The COSO Framework: A Primer and Tool for the Audit Committee" in this toolkit.)	☐	☐	☐	
2. Does the organization consider risks from external sources such as creditor demands, economic conditions, regulation, or labor relations?	☐	☐	☐	
3. Does the organization consider risks from internal sources such as cash management, investment management and documentation, information systems security, and backup systems?	☐	☐	☐	
4. Is the risk of a misstatement of the financial statements considered, and are steps taken to mitigate that risk?	☐	☐	☐	
5. If applicable, are the risks associated with foreign and offshore operations considered, including their impact on the financial reporting process?	☐	☐	☐	
Control Activities				
1. Does the organization have a process in place to ensure that controls as described in its policy and procedures manuals are applied as they are meant to be applied? Do the policy and procedures manuals document all important policies and procedures? Are these policies and procedures reviewed and updated on a regular basis? If so, by whom?	☐	☐	☐	
2. Do supervisory personnel review the functioning of controls? If so, how is that review conducted and how are the results used? Is appropriate and timely follow-up action taken on exceptions?	☐	☐	☐	

(continued)

Control Environment—Tone at the Top	Yes	No	Not Sure	Comments
Information and Communication				
1. Is a process in place to collect information from external sources, such as industry, economic, and regulatory information, that could have an impact on the organization or the financial reporting process, or both?	☐	☐	☐	
2. Are milestones to achieve financial reporting objectives monitored to ensure that timing deadlines are met?	☐	☐	☐	
3. Is necessary operational and financial information communicated to the right people in the organization on a timely basis and in a format that facilitates its use, including new or changed policies and procedures?	☐	☐	☐	
4. Is a process in place to respond to new information needs in the organization on a timely basis?	☐	☐	☐	
5. Is a process in place to collect and document errors or complaints to analyze, determine cause, and prevent a problem from recurring in the future?	☐	☐	☐	
6. Is a process established and communicated to officers, employees, and others, about how to communicate suspected instances of wrongdoing by the organization or employees of the organization? Further, does a process exist to ensure that anyone making such a report is protected from retaliation for making one? (See also the tool "Sample Whistle-Blower Tracking Report," in this toolkit.)	☐	☐	☐	
Monitoring				
1. Do officers and employees understand their obligation to communicate observed weaknesses in design or compliance with the internal control structure of the organization to the appropriate supervisory or management personnel?	☐	☐	☐	

Control Environment—Tone at the Top	Yes	No	Not Sure	Comments
Monitoring (cont.)				
2. Are interactions with external stakeholders periodically evaluated to determine if they are indicative of a weakness in the internal control structure? (For example, consider the frequency of complaints about incorrect invoices, statements, and acknowledgments.)	☐	☐	☐	
3. Is there follow-up on recommendations from the internal and external auditors for improvements to the internal control system?	☐	☐	☐	
4. Are personnel required to sign off, indicating their performance of critical control activities such as performing reconciliations?	☐	☐	☐	
5. Does the internal audit team have the right number of competent and experienced staff? Do they have access to the board of directors and audit committee? Is the reporting structure in place to ensure their objectivity and independence? Is the work of the internal audit team appropriate to the organization's needs, and prioritized with the audit committee's direction?	☐	☐	☐	

Fraud and the Responsibilities of the Audit Committee: An Overview

PURPOSE OF THIS TOOL: An audit committee should take an active role in the prevention and deterrence of fraud, as well as an effective ethics and compliance program. The audit committee should constantly challenge management and the auditors to ensure that the organization has appropriate antifraud programs and controls in place to identify potential fraud and ensure that investigations are undertaken if fraud is detected. The audit committee should take an interest in ensuring that appropriate action is taken against known perpetrators of fraud.

This tool is intended to make audit committee members aware of their responsibilities as they undertake this important role. This tool highlights areas of activity that may require additional scrutiny by the audit committee.

Fraud can be very costly to all types of organizations, including not-for-profit organizations. According to the Association of Certified Fraud Examiners (ACFE), U.S. organizations lose an estimated 7 percent of annual revenues to fraud.[1] Their research also indicates that there is anecdotal evidence that fraud at not-for-profit organizations may be even higher. This is due to the fact that not-for-profit organizations are not implementing the most effective fraud controls, such as whistle-blower hotlines and management review of financial statements, and are focusing their resources on the least effective fraud controls.[2] The cost of fraud not only includes the financial cost, but also costs such as damage to the organization's reputation, potential loss of donors or other resource providers, loss of management and board expertise, and many other nonfinancial costs.

Definition and Categories of Fraud

An understanding of fraud is essential for the audit committee to carry out its responsibilities. The term *fraud* is defined in Black's Law Dictionary (Sixth Edition, 1990) as

> An intentional perversion of truth for the purpose of inducing another in reliance upon it to part with some valuable thing belonging to him or to surrender a legal right. A false representation of a matter of fact, whether by words or by conduct, by false or misleading allegations, or by concealment of that which should have been disclosed, which deceives and is intended to deceive another so that he shall act upon it to his legal injury … A generic term, embracing all multifarious means which human ingenuity can devise, and which are resorted to by one individual to get advantage over another by false suggestions or by suppression of truth, and includes all surprise, trick, cunning, dissembling, and any unfair way by which another is cheated.

[1] Association of Certified Fraud Examiners (ACFE), *2008 Report to the Nation on Occupational Fraud and Abuse*, Austin, TX: ACFE, 2008, p 8.
[2] ACFE, *2008 Report to the Nation on Occupational Fraud and Abuse*, Austin, TX: ACFE, 2008, p 40.

The ACFE defines *occupational fraud* as

> The use of one's occupation for personal enrichment through deliberate misuse or misapplication of the employing organization's resources or assets[3]

The audit committee also needs to be aware that fraud affecting the organization often falls within one of the following three categories:

- *Management fraud*, which involves senior management's intentional misrepresentation of financial statements, or theft or improper use of an organization's resources.
- *Employee fraud*, which involves nonsenior employee theft or improper use of an organization's resources.
- *External fraud*, which involves theft or improper use of resources by people who are neither management, nor employees of the firm.

This categorization of fraud is useful, but not absolute. Middle management employees may intentionally misrepresent financial statement transactions, for example, to improve their apparent performance, or outside individuals may collude with organization management or employees.

Roles of the Audit Committee in the Prevention, Deterrence, Investigation, and Discovery or Detection of Fraud

The members of the audit committee should understand their role of ensuring that the organization has antifraud programs and controls in place to help prevent fraud, and aid in its discovery if it does occur, to properly fulfill their fiduciary duties of the following:

1. Monitoring the financial reporting process
2. Monitoring the internal control system
3. Overseeing the external audit and internal audit functions
4. Reporting findings to the board of directors
5. Monitoring and overseeing the whistle-blower policy and hotline

Guidance to boards of directors and trustees, audit committees, and management to help prevent, deter, and detect fraud is contained in the AICPA's Antifraud & Corporate Responsibility Resource Center available at www.aicpa.org/antifraud/homepage.htm. The information contained in the center can be viewed from different user perspectives for a personalized focus on the issues.

Not-for-profit organizations can use the specific requirements for audit committees as outlined in the Sarbanes-Oxley Act and the Securities and Exchange Commission rules as a guide. The requirements can be obtained from the AICPA Web site at www.aicpa.org/sarbanes/index.asp.

The audit committee should ensure that the organization has implemented an effective ethics and compliance program, and that it is periodically tested. Because the occurrence of significant frauds can frequently be attributed to an override of internal controls, the audit committee plays an important role to ensure that internal controls address the appropriate risk areas and are functioning as designed.

[3] ACFE, *2008 Report to the Nation on Occupational Fraud and Abuse*, Austin, TX: ACFE, 2008, p 6.

Internal auditors and external auditors can serve a vital role in aiding in fraud prevention and deterrence. Internal audit staff and external auditors that are experienced and trained in fraud prevention and deterrence can help to provide assurance that (1) risks are effectively identified and monitored, (2) organizational processes are effectively controlled and tested periodically, and (3) appropriate follow-up action is taken to address control weaknesses. The audit committee needs to ensure that internal and external auditors are carrying out their responsibilities in connection with potential fraud.

Whistle-Blowers

According to the ACFE, the most effective method for detection of fraud has historically been tips.[4] In many cases, these tips are obtained through the use of whistle-blower policies and hotlines. Not-for-profit organizations must establish procedures for the receipt, retention, and treatment of complaints received by the organization regarding accounting, internal accounting controls, or auditing matters; and the confidential, anonymous submission by employees of the organization of concerns regarding questionable accounting or auditing matters (see Sarbanes-Oxley Act of 2002, Title III, Section 301.) In many organizations, the audit committee is significantly involved monitoring the whistle-blower process. The audit committee chair or the entire committee may be involved in the primary investigation and review of the whistle-blower complaints and reporting. In addition, some organizations have designated the audit committee chair or an audit committee member as the individual who initially receives whistle-blower reports. See also the "Sample Whistle-Blower Tracking Report" in this toolkit.

When Fraud Is Discovered

Fraud can be discovered through many sources, namely, internal or external auditors, forensic accounting consultants, employees, vendors, and others. Establishing a confidential hotline can also be an important source of information leading to fraud discovery, as part of an organization's overall ethics, compliance, and fraud prevention program. Although a confidential hotline is something that could be accomplished internally, a variety of outside service providers can be engaged to provide this service for the organization.

If fraud or improprieties are asserted or discovered, the audit committee—through the external auditors, internal auditors, or forensic accounting consultants, as appropriate—should investigate, and, if necessary, retain legal counsel to assert claims on the organization's behalf. Forensic accounting consultants, in particular, may be needed to provide the depth of skills necessary to conduct a fraud investigation and, if it is desirable, to get an external assessment.

If fraud is discovered or there is a reasonable basis to believe that fraud may have occurred, the audit committee is responsible for ensuring that an investigation is undertaken. Criteria should be in place describing the audit committee's level of involvement, based on the severity of the offense. Most audit committees will also want to obtain information about all violations of the law and the organization's policies.

Forensic accounting consultants can also frequently provide audit committees with other related advisory services, namely, (1) evaluations of controls designs and operating effectiveness through compliance verification, (2) creation of special investigations units , (3) incident management committees, (4) disclosure risk controls, (5) ethics hotlines, (6) code of conduct, and other antifraud measures.

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[4] ACFE, *2008 Report to the Nation on Occupational Fraud and Abuse*, Austin, TX: ACFE, 2008, p 20.

The audit committee can engage the audit firm to carry out a forensic or fraud investigation. If CPA forensic accountants are engaged by the organization's general counsel, rather than the audit committee, they may potentially attain attorney-client privilege status, not otherwise available under normal circumstances.

Expertise of Forensic Accounting Consultants

In some situations, it may be necessary for an organization to look beyond the external audit team for expertise in the fraud area. In such cases, forensic accounting consultants can provide additional assurance or advanced expertise because they have special training and experience in fraud prevention, deterrence, investigation, and detection. Forensic accounting consultants may also provide fresh insights into the organization's operations, control systems, and risks. The work of forensic accounting consultants may also provide comfort for the organization's CEO and CFO. Forensic accounting consultants, however, cannot act as an insurer to prevent or detect fraud.

Many forensic accountants have obtained specific training in the identification and detection of fraud and may have additional designations such as certified fraud examiner. More information about certified fraud examiners may be located at the Web site for the ACFE at www.acfe.com

Conclusion

The public is demanding greater vigilance from all parties involved in organizational governance, thus increasing the need to fight fraud. Audit committees are required to play a pivotal role in the prevention and deterrence of fraud, and to take appropriate action in the discovery of fraud. External public accountants, hired by audit committees, and internal auditors will continue to play an important part in the process. Forensic accounting consultants have emerged, however, as vital, newly recognized allies. Qualified forensic accounting consultants have the education, training, and experience to provide additional assistance to audit committees so they may better carry out their fiduciary responsibilities in the fight against fraud.

Sample Whistle-Blower Tracking Report

PURPOSE OF THIS TOOL: The audit committee is responsible for establishing and maintaining a secure, confidential whistle-blower mechanism. A key defense against fraud and other significant deviations from organizational policies occurring in an organization is the availability of a means for employees and other constituents to anonymously report suspected wrongdoing (whistle-blowing). A 2008 survey conducted by the Association of Certified Fraud Examiners (ACFE) revealed that various forms of fraud committed in not-for-profit organizations were detected nearly 49 percent of the time by tips, by far the leading method for detecting fraud in all types of organizations.[1] As a result, the ACFE suggests that organizations should focus on employee education as a key component of their fraud detection strategies.[2] In addition, because 30 percent of the tips were received from external sources, ACFE also recommends opening the system to suppliers, customers, and others.[3]

Federal law prohibits retaliation against anyone “blowing the whistle” with respect to a violation of a federal law or regulation, which includes not-for-profit organizations.

When a not-for-profit organization institutes a whistle-blower program, this tool could be used by the audit committee and management to implement an appropriate policy and process, to review any complaints received regarding internal accounting controls or auditing matters, and to track complaints received to an appropriate resolution. The audit committee should have the authority to appropriate resources necessary to resolve such complaints, including the hiring of external experts or advisors (refer to the “Points to Consider When Engaging External Experts and Advisors tool).

It is a best practice to have whistle-blower complaints reported directly to the audit committee rather than to members of the organization’s management team. Therefore, not-for-profit organizations should exercise care in determining to whom whistle-blower complaints should be immediately reported if not made directly to the audit committee. Factors that should be considered include the size and complexity of the organization, as well as accessibility of the parties to whom such reports should be made. Smaller organizations that do not have an audit committee may choose to delegate such responsibilities to another committee, such as a finance committee, or to an individual, such as the board treasurer. It is also common for larger organizations to engage an independent third-party service provider to collect complaints, which may provide additional assurance to individuals who wish to remain anonymous, as well as greater consistency in complaint handling.

[1] Association of Certified Fraud Examiners (ACFE), *2008 Report to the Nation on Occupational Fraud and Abuse*, Austin, TX: ACFE, 2008, p 22.
[2] ACFE, *2008 Report to the Nation on Occupational Fraud and Abuse*, Austin, TX: ACFE, 2008, p 23.
[3] ACFE, *2008 Report to the Nation on Occupational Fraud and Abuse*, Austin, TX: ACFE, 2008, p 23.

Sample Whistle-Blower Policy

State regulatory requirements for establishing whistle-blower reporting programs and for the protection of employees from retaliatory actions should be considered in developing and implementing whistle-blower policies (see the following example). The whistle-blower policy should be disseminated as broadly as possible to ensure that all employees, board members, and volunteers are aware of the policy and protocols for reporting whistle-blower complaints. Consideration should therefore be given to incorporating whistle-blower policies in the employee handbook, posting whistle-blower policies to the organization's Web site, and distributing the policy to employees, board members, and volunteers on an annual basis.

ABC Organization Whistle-Blower Policy

General

The ABC Organization Code of Conduct (the code) requires directors, key volunteers, and employees to observe high standards of business and personal ethics in the conduct of their duties and responsibilities. Employees and representatives of the organization must practice honesty and integrity in fulfilling their responsibilities and comply with all applicable laws and regulations.

The objectives of the ABC Organization Whistle-Blower Policy are to establish policies and procedures for the following:

- The submission of concerns regarding questionable accounting or audit matters by employees, directors, officers, volunteers, and other stakeholders of the organization, on a confidential and anonymous basis
- The receipt, retention, and treatment of complaints received by the organization regarding accounting, internal controls, or auditing matters
- The protection of directors, volunteers, and employees reporting concerns from retaliatory actions

Reporting Responsibility

Each director, volunteer, and employee of ABC Organization has an obligation to report in accordance with this whistle-blower policy (*a*) questionable or improper accounting or auditing matters, and (*b*) violations and suspected violations of ABC Organization's code (concerns).

Acting in Good Faith

Anyone reporting a concern must act in good faith and have reasonable grounds for believing the information disclosed indicates an improper accounting or auditing practice, or a violation of the code. The act of making allegations that prove to be unsubstantiated, and that prove to have been made maliciously, recklessly, or with the foreknowledge that the allegations are false, will be viewed as a serious disciplinary offense. It may also result in discipline, up to and including dismissal from the volunteer position or termination of employment. Such conduct may also give rise to other actions, including civil lawsuits.

Confidentiality

Reports of concerns, and investigation pertaining thereto, shall be kept confidential to the extent possible, consistent with the need to conduct an adequate investigation.

Disclosure of reports of concerns to individuals not involved in the investigation will be viewed as a serious disciplinary offense and may result in discipline, up to and including termination of employment. Such conduct may also give rise to other actions, including civil lawsuits.

Authority of Audit Committee

All reported concerns will be forwarded to the audit committee in accordance with the procedures set forth herein. The audit committee shall be responsible for investigating and making appropriate recommendations to the board of directors, with respect to all reported concerns.

No Retaliation

This whistle-blower policy is intended to encourage and enable directors, volunteers, and employees to raise concerns within the organization for investigation and appropriate action. With this goal in mind, no director, volunteer, or employee who, in good faith, reports a concern shall be subject to retaliation or, in the case of an employee, adverse employment consequences. Moreover, a volunteer or employee who retaliates against someone who has reported a concern in good faith is subject to discipline up to and including dismissal from the volunteer position or termination of employment.

Reporting Concerns

Encouragement of Reporting

The organization encourages complaints, reports, or inquiries about illegal practices or serious violations of the code, including illegal or improper conduct by the organization itself, by its leadership, or by others on its behalf. Appropriate subjects to raise under this policy would include financial improprieties, accounting or audit matters, ethical violations, or other similar illegal or improper practices or policies. Other subjects on which the organization has existing complaint mechanisms should be addressed under those mechanisms, such as raising matters of alleged discrimination or harassment through the organization's human resources channels, unless those channels are themselves implicated in the wrongdoing. This policy is not intended to provide a means of appeal from outcomes in those other mechanisms.

Employees

Employees should first discuss their concern with their immediate supervisor. If, after speaking with his or her supervisor, the individual continues to have reasonable grounds to believe the concern is valid, the individual should report the concern to the director of human resources. However, if the individual is uncomfortable speaking with his or her supervisor, or the supervisor is a subject of the concern, the individual should report his or her concern directly to the director of human resources or a level above the supervisor. In addition, suspected fraud should be reported directly to the chair of the audit committee, who may be contacted by phone at (Telephone Number), by e-mail at (e-mail address) or by regular mail at:

Mr. or Ms. Jenkins, Audit Committee Chair

[insert mailing address]

If the concern was reported verbally to the director of human resources, the reporting individual, with assistance from the director of human resources, shall reduce the concern to writing. The director of human resources is required to promptly report the concern to the chair of the audit committee, which has specific and exclusive responsibility to investigate all concerns. If the director of human resources, for any reason, does not promptly forward the concern to the audit committee, the reporting individual should directly report the concern to the chair of the audit committee. Concerns may also be submitted anonymously. Such anonymous concerns should be in writing and sent directly to the chair of the audit committee.

Directors and Other Volunteers

Directors and other volunteers should submit concerns in writing directly to the chair of the audit committee.

Handling of Reported Violations

The audit committee shall address all reported concerns. The chair of the audit committee shall immediately notify the audit committee, the president, the CEO, and chief operating officer of any such report. The chair of the audit committee will notify the sender and acknowledge receipt of the concern within five business days, if possible. It will not be possible to acknowledge receipt of anonymously submitted concerns.

All reports will be promptly investigated by the audit committee, and appropriate corrective action will be recommended to the board of directors, if warranted by the investigation. In addition, action taken must include a conclusion or follow-up, or both, with the complainant for complete closure of the concern.

The audit committee has the authority to retain outside legal counsel, accountants, private investigators, or any other resource deemed necessary to conduct a full and complete investigation of the allegations.

INSTRUCTIONS FOR USING THIS TOOL: Before using this tool, the audit committee should review any applicable state or local laws or regulations, as well as the appropriate rules promulgated by other relevant regulatory bodies, if any.

Sample Tracking Report						
Date Submitted	Tracking Number	Description of Complaint	Submitted By*	Current Status **	Actions Taken	
					Date	Comments

* Submitted By Codes: Director (D); Volunteer (Vol); Client (C); Member (M); Vendor (Ven); Stakeholder (S); Other (O); Anonymous (A)

** Current Status Codes: Resolved (R); Under Investigation (UI); Dismissed (D); Withdrawn (W); Pending (P)

Guidelines for Hiring the Chief Audit Executive

PURPOSE OF THIS TOOL: An internal audit function is a key mechanism in the internal control structure for many organizations. It is recognized that many not-for-profit organizations cannot justify the expense of an internal auditor. In such cases, the function should be outsourced. Some have very large internal audit departments headed by a senior executive. It is becoming more common in larger organizations to refer to the person heading the internal audit function as the chief audit executive (CAE). This tool is aimed at not-for-profit organizations that have an internal audit department with at least one full time member. As used in this tool, the terms *chief audit executive* and *CAE* refer to the person responsible for the internal audit function, irrespective of their title or organizational role. Care must be taken in hiring the right CAE, one that matches the organization's needs with the necessary technical expertise and that meets other requirements (not-for-profit experience, temperament, integrity, management and human relationship skills, and others).

Role of the Audit Committee Regarding the CAE

The audit committee is responsible for developing, reviewing, and revising the position description of the CAE. The position description should be reviewed and agreed to with the internal person who has dotted line administrative responsibility for the CAE.

A critical activity of the audit committee is to be involved in the hiring of the CAE of the organization. Because the CAE reports to the audit committee, the committee should be responsible for ensuring that the CAE receives fair and timely performance reviews. The audit committee should have an active role in determining the annual salary adjustment for the CAE. The audit committee should be the decision-making party in any decision to terminate the CAE.

The CAE will have a high degree of interaction with the audit committee, so the audit committee should be comfortable working with this person. In all organizations, the CAE should report functionally to the audit committee and administratively to a senior executive of the organization. If this is not possible to do in a specific organization, the audit committee should develop the rationale for not following this most desirable practice and share it with the board of directors.

CAE Qualifications

In general, candidates for a CAE position should have distinguished themselves professionally by earning a CPA or certified internal auditor credential, or both, and should have significant experience in a management role and strong technical skills in accounting and auditing. In addition, because of the breadth of experience it offers, the audit committee should seek candidates that have experience in public accounting (or its equivalent) and possibly an advanced business degree, such as a master of business administration.

INSTRUCTIONS FOR THIS TOOL: The audit committee should consider asking the following questions of candidates that have passed the initial employment screening by the organization's human resource department, internal executive search committee, or an outside recruiting firm. This tool is meant to prepare the audit committee for the kinds of questions that should be asked of candidates for this important position. Note that some sample questions may not all be appropriate for your organization or the candidate. There may be a need for additional questions depending on the exact nature of the organization involved and the responses of the candidates to these suggested questions.

Chief Audit Executive—Sample Candidate Interview Questions	Interviewer Notes
1. What do you consider to be internal audit's role within the organization?	
2. Based on your review and knowledge of our organization to date, what do you see as the biggest challenges for an internal audit team in the short run (3 to 6 months), medium term (6 to 12 months), and over the next 2 to 3 years for us?	
3. What experience do you have in the not-for-profit industry, and how do you plan to keep abreast of the significant developments relevant to internal audit in the not-for-profit industry?	
4. If applicable, what is your experience in addressing different business practices in different countries?	
5. Have you ever been offered a gratuity or a payment that might or could be construed as a bribe? What were the circumstances, and how did you handle the situation?	
6. Have you worked with audit committees in the past? What processes have you put in place to keep the audit committee fully and appropriately informed? In the course of a year, what is the typical number of meetings or communications between the chief audit executive (CAE) and the audit committee (chair)? Describe the nature of each interaction and your role in them.	
7. Give some examples of situations you have faced that required special meetings with the audit committee in executive session as a result of disagreements with management. How were these situations resolved with management? Have there been situations in which management has tried to alter or suppress your recommendations or discredit your findings, and how did you respond to this? In retrospect and based on your added experiences, would you now handle these situations at all differently and if so why?	

Chief Audit Executive—Sample Candidate Interview Questions	Interviewer Notes
8. Have you worked with the Committee of Sponsoring Organizations of the Treadway Commission (COSO) internal control framework? How has the framework influenced your process in evaluating the adequacy of internal controls? How is this framework used to design your internal audits?	
9. At previous organizations where you were employed, what type of technology platform was used? Have you been involved in a technology system implementation? What role did you play in the process and how did you make sure that the proper controls were in place when the system went live?	
10. Have you used technology in conducting internal audits, and how has it enhanced your conduct of the internal audit? If you have used technology what was it? (This should be compared to the technology used by the hiring organization for relevance). How would you recognize a problem that might exist either in the internal audit data or in the organization's records? What would you do about it?	
11. Do you use a formal project planning process that is applied consistently for all internal audits? If so, what benefits have you derived in meeting your team's goals and objectives? What is your average report cycle time from the end of fieldwork to issuance of your final report with management comments included?	
12. Have you ever conducted a formal risk assessment and, if so, how have you incorporated it into setting up an audit plan?	
13. What role does the organization's strategic and technology plans play in the development of an audit plan?	
14. Have you gone out to subsidiaries or affiliate locations to ensure that they have significant input into audit objectives and scopes? How was this achieved? How have you resolved differences of opinion in this area without compromising the goals you have established for an audit?	

(continued)

Chief Audit Executive—Sample Candidate Interview Questions	Interviewer Notes
15. What role have you played in assisting subsidiary or affiliate locations in implementation of recommendations? • When you or your team conducts an internal audit, what relationship do you try to have between the employees in the audited area and you and your staff? What relationship do you think is best to have with the area being audited, senior management, and yourself as CAE? Explain how you have developed this type of relationship in past positions you have held. What specific things have you done in the past to improve the effectiveness and efficiency of the operations and controls in each audit area? How would you make your recommendations to management? What process would you use to resolve differences of opinion? • In conducting internal audits, have you made recommendations for improving the effectiveness and efficiency of the operations and controls in audit areas? If so, how have those recommendations been transmitted to management? What processes have you used to resolve any ensuing differences of opinion, and how effective have such processes been?	
16. Would you use a process for conducting a customer satisfaction survey after an internal audit is completed? How would you integrate this feedback into future audits?	
17. How would you ensure that the personnel in internal audit have the necessary skills to ensure an adequate understanding of the organization's accounting and other business practices?	
18. How many people have you managed, either as direct reports or within an organization, that you might have overseen? How would you describe your management style?	
19. Have you ever participated in a 360-degree assessment process? (A *360-degree evaluation* is one that obtains anonymous feedback from a group of individuals representing various perspectives.) If so, what did you learn about yourself that surprised you? How did the results of the assessment change your behavior?	

Chief Audit Executive—Sample Candidate Interview Questions	Interviewer Notes
20. Have you participated in an executive (in-camera) sessions with an audit committee? If so, what was the nature of these meetings and have you ever had to raise a major, unresolved issue at such a meeting? If so, how did it get resolved?	
21. What process have you used to ensure that management acts on your recommendations? Give a specific example of a difficult situation that got resolved as a result of your direct input.	
Other Notes and Questions	
1. If applicable, has your internal audit department ever had a peer review? What were the results of that review?	

Evaluating the Internal Audit Team: Guidelines and Questions

PURPOSE OF THIS TOOL: The sample questions included in this tool are only a starting point to assist the audit committee in evaluating the performance and effectiveness of the internal audit team. Follow-up questions should be considered as appropriate. Please also note that many not-for-profit organizations are not large enough to necessitate the formation of an internal audit team. Each organization's audit committee should evaluate the need for such a team before implementing one. Internal audit is a function that can also be outsourced, which may allow an organization the opportunity to have an internal audit function in a more cost-effective manner.

Audit Committee or Board Relationship With Internal Audit Team

It is in the best interest of all concerned for the audit committee or board of directors and the internal audit team to maintain a strong positive relationship. The audit committee should view the internal audit team as its eyes and ears about what is going on within the organization. The audit committee should promote a relationship of healthy professional skepticism between the chief audit executive (CAE) and the CFO, though it is these two individuals that will likely spend the most time working with the audit committee.

The audit committee chair and the leader of the internal audit team (the CAE) should have frequent contact between meetings of the audit committee. In fact, the CAE should have a "solid-line" reporting relationship to the audit committee (with a "dotted-line" reporting relationship to a senior executive in the organization for administrative purposes), and the audit committee should be consulted before the CAE can be hired, fired, or reassigned.

At every audit committee meeting, the committee should hold an executive session with the CAE to ask specific questions (see the tool, "Conducting an Audit Committee Executive Session: Guidelines and Questions" in this toolkit). It is best for the audit committee to ask specific, yet open-ended questions, and to probe deeper with the CAE on answers that might be puzzling or incomplete. The CAE should be forthcoming with information including the results of audits conducted, as well as the audit currently underway. The internal audit team must recognize that it is an agent of the audit committee and not management.

The CAE should be the keeper of the audit committee charter and should consult with the committee chair and the CFO in developing meeting agendas.

Periodically, the CAE should review with the audit committee the staffing needs of the internal audit team and the competencies of the individuals filling those positions. As a best practice, the internal audit team should not be the victim of a downsizing; in fact, it is at precisely this time that the internal audit team should be doing extra monitoring regarding the safeguarding of assets, the integrity of the internal control system, and related matters.

Discussions between the CAE and the audit committee should also address the competencies of the financial management team. The internal audit team is in the best position to determine whether the financial management team is able to address complex accounting issues on its own, or whether it relies too heavily on the external auditors or other consultants for evaluation and decision-making.

The audit committee should also promote a positive working relationship between the CAE and the external auditors. If possible, the external auditors should rely on the work of the internal auditor to supplement or limit their own testing. Generally accepted auditing standards require that the external audit firm maintain control of the work being performed on its behalf, and to reperform some of the testing to reach its own conclusion about the work of the internal auditor.

Finally, the audit committee should periodically assess the performance of the CAE and the internal audit team to ensure that they are the appropriate agent of the audit committee in the organization. The following tool includes some sample questions that the audit committee should ask itself in evaluating the effectiveness of the internal audit team.

INSTRUCTIONS FOR USING THIS TOOL: The sample questions included in this tool are only a starting point to evaluate the performance and effectiveness of the internal audit team. Audit committee members should ask follow-up questions when appropriate.

Evaluation of Internal Audit Team	Yes	No	Not Sure	Comments
1. Does the internal audit department have a formal audit methodology focusing on risks?	☐	☐	☐	
2. Does the audit methodology drive the development of an annual or long range audit plan?	☐	☐	☐	
3. Is the audit plan reviewed by the audit committee at least annually?	☐	☐	☐	
4. Does the audit plan contain sufficient flexibility to adjust for any unforeseen risks that may surface during the year?	☐	☐	☐	
5. Does the chief audit executive and his or her staff assess management's "tone at the top" in developing the audit plan?	☐	☐	☐	
6. Does senior management have professional respect for the internal audit function?	☐	☐	☐	
7. Does the department appear to be using its time and resources effectively and efficiently in performing the audit plan?	☐	☐	☐	
8. Are the department's size and structure adequate to meet its established objectives?	☐	☐	☐	
9. Is the experience level of the internal auditors adequate?	☐	☐	☐	
10. Does the department appear to be objective? Describe the procedures that are performed to ensure objectivity.	☐	☐	☐	
11. Is the technical knowledge of the department members sufficient to ensure that duties are performed appropriately?	☐	☐	☐	
12. Does the department have an appropriate continuing education program?	☐	☐	☐	

(continued)

Evaluation of Internal Audit Team	Yes	No	Not Sure	Comments
13. Are there department members with sufficient information systems auditing expertise to address the level of technology used by the organization?	☐	☐	☐	
14. Is the department's work planned appropriately?	☐	☐	☐	
15. Does planning include written audit plans and programs?	☐	☐	☐	
16. What types of reports are issued by the internal audit department and to whom?				
Notes:				
17. Are the internal audit reports issued on a timely basis?	☐	☐	☐	
18. Do the internal audit reports include sufficient detail for effective action by management or the audit committee, or both?	☐	☐	☐	
19. Does management respond in an appropriate and timely fashion to significant recommendations and comments made by the internal auditors?	☐	☐	☐	
20. Do internal audit procedures encompass operational as well as financial areas?	☐	☐	☐	
21. To what extent does the internal audit team perform certain preparatory audit procedures, including internal control grids, for the external auditors that would alleviate management from this task?				
Notes:				

Evaluation of Internal Audit Team	Yes	No	Not Sure	Comments
22. To what extent does the internal audit team "dialog" with the organization's external auditors, including review of management letter comments and regulatory audit reports, for example, Office of Management and Budget Circular A-133?				
Notes:				
23. To what extent is the internal audit team involved with management and the external auditors to plan the scope of the external audit, with reference to internal audit areas reviewed by the team since the last external audit?				
Notes:				
24. Was the department's involvement in the annual audit effective?	☐	☐	☐	
25. What could be done in the future to maximize the department's effectiveness and efficiency?				
Notes:				
26. To what extent is outsourcing used in the internal audit function, what areas are outsourced, and to whom are they outsourced?				
Notes:				

(continued)

Evaluation of Internal Audit Team	Yes	No	Not Sure	Comments
27. Is outsourcing done to gain expertise not found in the internal audit department?	☐	☐	☐	
28. Is outsourcing done to minimize costs?	☐	☐	☐	
29. Does the internal audit team have a periodic peer review performed and, if so, what were the results of the latest review?				
Notes:				
30. What criteria are used to establish and prioritize the annual and long-range internal audit plan?				
Notes:				
31. Is the department's work concentrated in areas of high risk, judgment, and sensitivity?	☐	☐	☐	
32. To what extent does the internal audit team keep itself informed about, and involved in, professional activities?				
Notes:				
33. What are the internal auditors' views regarding controls, the risk of fraud, and compliance matters?				
Notes:				
34. Has the charter of the internal audit department been evaluated to determine that it is still appropriate?	☐	☐	☐	

Evaluation of Internal Audit Team	Yes	No	Not Sure	Comments
35. To what extent is the internal audit team itself informed about the not-for-profit environment by membership and leadership in industrywide monitoring and watchdog groups?				
Notes:				
36. To what extent does the internal audit team react to news and information about industrywide events and possible areas of exposure posed by other not-for-profit organizations?				
Notes:				
37. To what extent is the internal audit team involved with the exit conferences between management and regulatory and compliance auditors?				
Notes:				
38. To what extent does the internal audit team "sign off" on resolutions of management comments by outside external auditors?				
Notes:				
Other Questions or Comments				

Other Questions or Comments	

PART IV: Audit Committee—External Auditors and Resources

Sample Request for Qualifications and Request for Proposal Letter for CPA Services

PURPOSE OF THIS TOOL: This tool contains sample language that may be used by an organization when requesting a proposal letter from qualified CPA firms when seeking a new service provider. As such, the sample letter may be subject to audit committee review or discussion, if an audit committee exists. Because the request for proposal (RFP) may require both the organization and a CPA firm to invest significant time to fully respond, an organization may want to first send a request for qualifications to determine the most qualified firms to request an RFP from.

Request for Qualifications

1. Describe your firm, discussing its audit philosophy, including the use of technology, and how it may differ from other firms.
2. Describe in particular, your firm's local office; that is, partners, staff, and clients served.
3. Describe your firm's local and national not-for-profit practice, including participation in professional, government, or other organizations related to the not-for-profit industry. Please also describe organizations similar to us.
4. Provide a list of other not-for-profit organizations your firm audits, both locally and nationally. Additionally, please indicate those not-for-profit organization clients your firm has obtained during the last three years.
5. Identify the partners and managers who might be assigned to the audit. Please provide bios. Also, please identify other professionals resident in your local office who are qualified to serve our organization and their experience serving similar organizations.
6. Describe your firm's capabilities and commitment to provide tax, information systems consulting and other management services to not-for-profit organizations. Identify any that are unique in this field.
7. Please provide local not-for-profit references from clients for whom you provide similar services.

Request for Proposal

[*Organization Letterhead*]

[*Date*]

[*Managing Partner*]
[*CPA Firm*]
[*Street Address*]
[*City, State, Zip*]

Dear Sir or Madam:

Our organization is accepting proposals from CPA firms to provide audit (and tax) services for our organization in the future. We invite your firm to submit a proposal to us by June 30, 20XX, for consideration. A description of our organization, the services needed, and other pertinent information follows:

Background of ABC Organization

ABC Organization is a 501(c)(6) trade association, with a related 501(c)(3) foundation, representing manufacturers of widgets. Annual revenues are between $10 million and $12 million per year, and the organization employs 35 people in 1 location. The organization is membership-based and has approximately 20,000 members worldwide. The organization has a June 30 fiscal year-end, with a requirement to file an audited financial statement with the bank and general membership by September 30 of each year.

Services to Be Performed

Your proposal is expected to cover the following services:

1. Annual audit to be completed in compliance with the previously mentioned filing requirement and meetings with audit committee and or board of directors, as necessary
2. Tax filings for the organization and related foundation
3. Quarterly reviews of internally prepared financial statements

Key Personnel

Following are key contacts for information you may seek in preparing your proposal:

Mr. Hobby	CEO	(123) 456-7891
Ms. Mims	CFO	(123) 456-7892
Mr. Olsen	Controller	(123) 456-7893
Ms. Biggs	Director, Internal Audit	(123) 456-7894

Requests for additional information, visits to our site, review of prior financial statements and tax returns, and appointments with the CEO or CFO should be coordinated through our controller. You may reach her at the number listed in this proposal. Please return the completed proposal to my attention at the address provided.

Relationship With Prior CPA or Current Service Provider

These services have been provided by XYZ, CPAs. However, that firm is no longer able to provide the services our organization requires. In preparing your proposal, be advised that management will give permission to contact the prior auditors.

[*You may use this section to disclose whether the decision to change auditors is a function of changes in your organization, changes in the audit firm, or result of a periodic review of your satisfaction with the services provided. Other aspects of your relationship with the prior auditor that you are willing to disclose at this stage in the proposal process may also be described here. CPA firms may request additional information, which you may choose to disclose only if the CPA firm signs a nondisclosure agreement.*]

Other Information

[*Use this space to discuss other information that a CPA firm may need to make an informed proposal on the accounting and/or auditing work that you require. As mentioned earlier, you should only disclose information here that you are comfortable disclosing; additional information may be available to the CPA firms interested in making a serious proposal only after signing a nondisclosure agreement.*]

Your Response to This Request for Proposal

In responding to this request, we request the following information:

1. Detail your firm's experience in providing auditing and tax services to organizations in the not-for-profit industry, as well as associations of a comparable size to ABC Organization, including those with international memberships.
2. Provide information on whether you provide services to any related industry associations or groups.
3. Discuss the firm's independence with respect to ABC Organization.
4. Discuss commitments you will make to staff continuity, including your staff turnover experience in the last three years.
5. Identify the five largest not-for-profit clients your firm (or office) has lost in the past three years and the reasons. Also discuss, in instances when loss of the client was due to an unresolved auditing or accounting matter, the process of attempting to resolve the issue(s).
6. Identify the partner, manager, and in-charge accountant who will be assigned to our job if you are successful in your bid, and provide biographies. Indicate any complaints against them that have been leveled by the state board of accountancy or other regulatory authority, if any. Indicate any corrective actions that have been taken by the firm with respect to these people.

7. Describe how your firm will approach the audit of the organization, including the use of any association or affiliate member firm personnel and the areas that will receive primary emphasis. Also discuss the firm's use of technology in the audit. And finally, discuss the communication process used by the firm to discuss issues with the management and audit committees of the board.
8. Set forth your fee proposal for the 20XX audit, with whatever guarantees can be given regarding increases in future years. Provide your proposed fee for the required quarterly review work and for tax preparation. Your fee proposal should also delineate hours by level of staff.
9. Describe how you will bill for questions on technical matters that may arise throughout the year.
10. Furnish current standard and discounted billing rates for classes of professional personnel.
11. Provide the names and contact information for other similarly sized clients of the partner and manager that will be assigned to our organization for reference purposes.
12. Describe how and why your firm is different from other firms being considered, and why our selection of your firm as our external accountants is the best decision we could make.
13. Include a copy of your firm's most recent peer review report, the related letter of comments, and the firm's response to the letter of comments.

Evaluation of Proposals

ABC Organization will evaluate proposals on a qualitative basis. This includes our review of the firm's peer review report and related materials, interviews with senior engagement personnel to be assigned to our organization, results of discussions with other clients, and the firm's completeness and timeliness in its response to us.

We would also appreciate a response if you decline to submit a proposal.

Sincerely,

Ms. Shelmon, CPA
Chief Financial Officer

Attachments:
Most recent financial statements and IRS Form 990.

Evaluating the Auditor's Engagement Letter: Questions to Consider

PURPOSE OF THIS TOOL: The audit committee should have the responsibility to recommend to the board of directors the hiring and firing of the external auditors. The audit committee should either be responsible for the engagement letter with the external auditors or recommend that letter to the board of directors. The audit committee should discuss a series of questions about the audit engagement letter (service agreement) with the external auditor in discharging this responsibility.

The engagement letter should be reviewed to ensure that the terms of the letter are consistent with those that were stated in the proposal received by the organization in response to its request for proposal in terms of scope of the audit, resources being provided by the auditor, obligations of financial management, and fees being charged.

The financial management of the organization should be consulted regarding its agreement with the details of the audit engagement, including timing of the work and the level of assistance to be provided by the organization's staff.

INSTRUCTIONS FOR USING THIS TOOL: The sample questions included in this tool are a starting point to evaluate the engagement letter with the external auditors. Audit committee members should answer the following questions with consultation of the auditor and financial management, as needed.

Evaluating the Auditor's Engagement Letter	Yes	No	Not Sure	Comments
1. Does the engagement letter address the scope of work to be performed? • Audit of financial statements • Supplemental information • Compliance reports • Generally accepted government auditing standards (also known as the Yellow Book) • Office of Management and Budget (OMB) requirements—Single audit OMB Circular A-133 • Tax filings • Other requirements	☐	☐	☐	
2. Does the engagement letter include a timetable for the audit work including dates for the following: • Interim fieldwork, if applicable • Provision of year-end trial balance • Completion of client-prepared schedules • Beginning of year-end fieldwork • End of year-end fieldwork • Delivery of draft of financial statements • Delivery of final financial statements • Delivery of management letter, if applicable	☐	☐	☐	

Evaluating the Auditor's Engagement Letter	Yes	No	Not Sure	Comments
• Required communications letter (Statement on Auditing Standards [SAS] No. 61, *Communication With Audit Committees* [AICPA, *Professional Standards*, vol. 1], which was superseded by SAS No. 114, *The Auditor's Communication With Those Charged With Governance* [AICPA, *Professional Standards*, vol. 1, AU sec. 380]) • Meetings with audit committee				
3. Does the letter discuss third-party reliance on the auditor's report?	☐	☐	☐	
4. Does the letter identify the persons or entities that will use the audit report and for what purpose?	☐	☐	☐	
5. Does the letter include estimates of the professional fees to be charged for the engagement and make provision for the handling of out-of-pocket expenses?	☐	☐	☐	
6. Does the letter provide for an agreed-upon process for changes in the scope of work?	☐	☐	☐	
7. Does the letter indicate the payment terms for the fees and costs and whether there are any finance charges for late payment?	☐	☐	☐	
8. Are mediation or arbitration terms discussed should a dispute or claim arise in connection with the performance or breech of the engagement agreement?	☐	☐	☐	
9. Does the letter contain a severability clause to address the possibility that a portion of the letter may be determined to be invalid?	☐	☐	☐	
10. Does the engagement letter require a written acceptance by the organization?	☐	☐	☐	
11. Does the letter include discussion of assistance that is expected to be provided during the audit by the organization's personnel?	☐	☐	☐	

(continued)

Evaluating the Auditor's Engagement Letter	Yes	No	Not Sure	Comments
12. Does the letter address how adjustments below the auditor's materiality threshold will be handled? (For example, does it address how they will be communicated to management for possible recording in the subsequent year's financial statements?)	☐	☐	☐	
13. Does the letter address the use of e-mail communications and related disclaimers regarding privacy?	☐	☐	☐	
14. Does the letter address the provision of a safe environment by the organization for the audit staff?	☐	☐	☐	
15. Does the letter address the auditor's record retention policy?	☐	☐	☐	
16. Does the letter address how the auditor will respond to circumstances that create a potential or actual conflict of interest?	☐	☐	☐	
17. Does the letter address how the auditor will respond to outside inquires related to the audit engagement?	☐	☐	☐	
18. Does the letter discuss the auditor's privacy policy regarding the organization's financial information?	☐	☐	☐	
19. Does the letter include a schedule of information to be provided by the organization, such as permanent file documents and schedules prepared by the organization's staff in connection with the audit engagement?	☐	☐	☐	
20. Does the letter indicate that nonattest services are excluded from this engagement and are subject to a separate written understanding before any additional services are commenced?	☐	☐	☐	

Evaluating the Auditor's Engagement Letter	Yes	No	Not Sure	Comments
Other Comments, Additional Questions				

Required Communications with the External Auditors: What to Expect

PURPOSE OF THIS TOOL: Auditing standards issued by the AICPA require the auditor to document required communications with those charged with governance.

The auditing standard uses the phrase "those charged with governance" to refer to those with responsibility for overseeing the strategic direction of the organization and obligations related to the accountability of the organization, including overseeing the organization's financial reporting process. External auditors, in the wake of well-documented audit failures, are required to increase their documentation and communication efforts as they relate to their interactions with the audit committee. The following sections list matters that must be communicated to the audit committee by the external auditors. This list is not meant to indicate that this is all that the auditor is communicating to the audit committee.

Auditor's Responsibility Under Generally Accepted Auditing Standards

It is important for audit committees to understand what an audit is and what it is not. Usually, audit committees are most concerned about the system of internal control and that the organization's financial statements are free of material misstatement. The auditor should make sure the audit committee understands the level of responsibility that the auditor assumes for the system of internal control and the financial statements under generally accepted auditing standards. It is also important that the auditor makes sure that the audit committee understands that an audit is designed to obtain reasonable rather than absolute assurance about the financial statements.

Significant Accounting Policies

The auditor should ensure that the audit committee is informed about all significant accounting policies, including significant changes in accounting standards, and how they are applied in the organization. To make sure, the audit committee should expect that the auditors will communicate the following:

1. All significant accounting policies, including those that are applied for the first time or changed during the year
2. How those accounting policies are applied in the organization
3. Methods the organization used to account for significant unusual transactions
4. The effect of significant accounting policies in controversial or emerging areas for which there is a lack of authoritative guidance or consensus (for example, revenue recognition, off-balance-sheet financing)
5. The existence of alternative policies that management had the option to apply, and why a certain policy was chosen

Auditor's Discussions Regarding the Organization's Accounting Principles

Although objective criteria for evaluating the quality of an organization's accounting practices have not been established, the auditor's judgments about the quality, not just the acceptability of the organization's accounting principles as applied in its financial statements, including disclosures, should be discussed. The discussion should be open and frank, and tailored to the organization's specific circumstances. It should include the following topics:

1. Consistency of the organization's accounting principles and their application
2. Clarity of the financial statements and related disclosures
3. Completeness of the financial statements and related disclosures
4. Any items that have a significant impact on the representational faithfulness, verifiability, and neutrality of the accounting information included in the financial statements, examples of which follow:
    a. Selection of new accounting policies or changes to current ones
    b. Estimates, judgments, and uncertainties
    c. Unusual transactions
    d. Accounting policies relating to significant financial statement items, including the timing of transactions and the period in which they are recorded
5. A discussion of accounting practices that are not specifically addressed in the accounting literature, for example, those that may be unique to the not-for-profit industry.

Management Judgments and Accounting Estimates

Accounting estimates are an integral part of the financial statements prepared by management. These estimates are based on management's judgments (which are normally based on management's knowledge and experience about past and current events), and assumptions about future events.

The auditor should address the following issues with the audit committee:

1. The process used by management in formulating particularly sensitive accounting estimates
2. The basis for the auditor's conclusion about the reasonableness of those estimates
3. The criteria used by management in formulating applicable accounting estimates

Audit Adjustments

The auditor should inform the audit committee about all audit adjustments arising from the audit that could, in the auditor's judgment, have a significant effect on the organization's financial reporting process. The audit team will keep track of those proposed adjustments for later discussion with management. Management will evaluate those proposed adjustments and decide whether the adjustment should be booked to the account balances as proposed. The auditor may find it necessary to qualify the audit report if management does not record the adjustments that the auditor deems necessary to record.

As part of its communications, the auditor should

1. inform the audit committee about proposed adjustments arising from the audit that could either individually or in the aggregate have a significant effect on the organization's financial reporting process.
2. address whether the proposed adjustments were recorded by management.
3. determine whether the proposed adjustments may not have been detected except through the auditing procedures performed (meaning that the organization's own internal control system did not detect the need for the adjustment).
4. explain about unadjusted amounts or uncorrected misstatements aggregated by the auditor during the current engagement and pertaining to the most recent period presented in the financial statements that were determined by management to be immaterial, both individually and in the aggregate, to the financial statements taken as a whole.

Other Information Contained in Audited Financial Statements

Although the notes to the financial statements are an integral part of the financial statements and therefore are included in the scope of the auditing procedures, other information prepared by management that may accompany financial statements is not necessarily included in the scope of the auditing procedures.

The auditor should discuss the responsibility, if any, that he or she has for other information in documents containing audited financial statements, any procedures performed, and the results.

Consider significant events occurring subsequent to the year under audit and the validity of including disclosure of them in the notes to the financial statements.

Disagreements With Management

Disagreements may arise between the auditor and management over the application of accounting principles to specific transactions and events, as well as the basis for management's judgments about accounting estimates, or even the scope of the audit or disclosures to be made in the financial statements or footnotes. Differences of opinion based on incomplete facts or preliminary information that are later resolved are not considered disagreements for this purpose.

When meeting with the audit committee, the auditors should discuss any disagreements with management, whether or not resolved, about matters that individually or in the aggregate could be significant to the organization's financial statements or the auditor's report.

The auditor should indicate whether management uses best judgment and best industry practice in applying accounting principles on an ongoing basis.

Consultation With Other Accountants

Sometimes, management of the organization may consult with other accountants about accounting and auditing matters. If the auditor is aware that such consultation has occurred, the auditor should discuss with the audit committee their views about the significant matters that were the subject of the consultation. The audit committee may wish to ask management whether they have consulted with other accountants about accounting and auditing matters.

The audit committee should be concerned about possible "opinion shopping" by management on critical issues.

Major Issues Discussed With Management Prior to Retention

The auditor should discuss with the audit committee any major issues that were discussed with management in connection with the initial or recurring retention of the auditor. This includes any discussions regarding the application of accounting principles or auditing standards.

Difficulties Encountered in Performing the Audit

The auditor should inform the audit committee about any serious difficulties encountered in working with management during the audit. Examples include, but are not limited to, the following:

1. Unreasonable delays by management in allowing the commencement of the audit.
2. Unreasonable delays by management in providing needed information to the auditor.
3. Unreasonable time table set by management for the conduct of the audit.
4. Unavailability of client personnel.
5. Failure of client personnel to complete client-prepared schedules on a timely basis.
6. The audit committee should inquire if the auditor unreasonably delayed the audit due to staff scheduling conflicts, or other significant time delays on their part.

Illegal Acts

The auditor has the responsibility to adequately inform the audit committee of any illegal acts that come to the auditor's attention (this communication need not include matters that are clearly inconsequential). The communication should describe (1) the act, (2) the circumstances of its occurrence, and (3) the effect on the financial statements.

What is an *illegal act* for purposes of this communication? Statement on Auditing Standards No. 54, *Illegal Acts by Clients* (AICPA, *Professional Standards*, vol. 1, AU sec. 317), defines it as violations of laws or government regulations attributable to the organization, or acts by management or employees on behalf of the organization. Illegal acts do not include personal misconduct by the organization's personnel unrelated to their business activities.

Internal Control Matters

See also the tool “Internal Control: A Tool for the Audit Committee” in this toolkit.

Internal Control matters should be discussed with the audit committee because they represent significant deficiencies in the design or operation of the internal control system, which could adversely affect the organization’s ability to initiate, record, process, and report financial data consistent with the assertions of management in the financial statements.

Fraud

See also the tool “Fraud and the Responsibilities of the Audit Committee: An Overview” in this toolkit.

Fraud involving senior management, or any fraud that comes to the auditor’s attention (whether caused by senior management or other employees) and creates a material misstatement of the financial statements, must be reported to the audit committee by the external auditor.

Evaluating the External Auditors: Questions to Consider

PURPOSE OF THIS TOOL: The audit committee (or the board of directors, if no separate audit committee exists) should have the responsibility to hire, terminate, and evaluate the external auditors. In discharging these responsibilities, the audit committee should consider a series of questions about its relationship with the external auditor and should ask key executives in the organization for their comments as well. This tool could also be utilized to evaluate other professional vendors, such as investment managers, insurance brokers, and bankers.

In considering information gathered through the process of evaluating the external auditors, it is important that the audit committee give consideration to the source of the information. For example, if the CFO or controller comments that he or she believes the auditor went too far in certain areas, which would probably carry less weight in audit committee deliberations than if the CFO or controller comments that certain areas were not tested adequately. As with all deliberative processes, the audit committee should consider the different perspectives and motivations of those having input into the deliberations.

Any communications with the external auditors undertaken in the evaluation process should be conducted with tact and acknowledgment of the need to maintain the open flow of communication between the external auditors and the audit committee.

INSTRUCTIONS FOR USING THIS TOOL: The sample questions included in this tool are only a starting point to evaluate the performance and effectiveness of the external auditors. Audit committee members should ask follow-up questions as appropriate.

Evaluation of the External Auditors	Yes	No	Not Sure	Comments
Questions for Audit Committee Members				
1. Did the auditors meet with the audit committee when requested?	☐	☐	☐	
2. Did the auditor address issues of "tone at the top" and antifraud programs and controls in place in the organization?	☐	☐	☐	
3. Did the auditors inform the audit committee of any risks of which the committee was not previously aware?	☐	☐	☐	
4. Did the auditor adequately discuss issues of the quality of financial reporting, including the applicability of new and significant accounting principles?	☐	☐	☐	
5. Did the auditor communicate issues freely with the audit committee, or did he or she seem protective of management?	☐	☐	☐	
6. Does it appear that management exercises undue influence on the external auditors?	☐	☐	☐	
7. Does it appear that the external auditors are reluctant or hesitant to raise issues that would reflect negatively on management?	☐	☐	☐	
8. Is the audit committee satisfied with the planning and conduct of the audit, including the financial statements and internal control over financial reporting (as applicable)?	☐	☐	☐	
9. Is the audit committee satisfied that the external auditor remains independent and objective both in fact and appearance? • Review all audit-related and nonaudit services conducted by the external auditor in the prior year.	☐	☐	☐	

Evaluation of the External Auditors	Yes	No	Not Sure	Comments
Questions for Audit Committee Members (cont.)				
• Consider whether there are indications that the firm, the office, or the partner is significantly dependent on the organization for its fee income. • Review whether former members of the audit team are now employed by the organization. If any of these conditions exist, the audit committee should consider whether they impair the independence with respect to the organization. (See the tool "Independence and Related Topics: Conflict of Interest, Related Parties, Inurement, and Other Issues")				
10. Is the audit committee satisfied with its relationship with the auditors? In making this determination, the audit committee should consider (*a*) whether the partner-in-charge of the audit participated in audit committee meetings, (*b*) whether the auditors were frank and complete in the required discussions with the audit committee, (*c*) whether the auditors were frank and complete during executive (in-camera) sessions with the audit committee, and (*d*) whether the auditors were on time in their delivery of services to the organization.	☐	☐	☐	
11. Was the audit fee fair and reasonable in relation to what the audit committee knows about fees charged to other nonprofit organizations, and in line with fee benchmarking data the audit committee might have available to it?	☐	☐	☐	
12. Did the external auditors provide constructive observations, implications, and recommendations in areas needing improvement, particularly with respect to the organization's internal control system over financial reporting?	☐	☐	☐	

(continued)

Evaluation of the External Auditors	Yes	No	Not Sure	Comments
Questions for Audit Committee Members (cont.)				
13. Did the external auditors demonstrate an ongoing understanding of the nature of nonprofit organizations, especially those operating in the sector of this organization?	☐	☐	☐	
Following are some questions the audit committee should ask different individuals in the organization to assist in evaluating the performance of the external auditors.				
Questions for the Organization's CEO				
1. From your perspective in working with the external auditors, are you satisfied with the scope, nature, extent, and timing of testing performed by the external auditors?	☐	☐	☐	
2. Are you satisfied with the knowledge, skills, and abilities of the staff assigned to the audit work?	☐	☐	☐	
3. Are you satisfied with the engagement leadership assigned, including the partner(s), manager(s), and fieldwork leaders?	☐	☐	☐	
4. Did the external auditors provide constructive observations, implications, and recommendations in areas needing improvement, particularly with respect to the organization's internal control system over financial reporting?	☐	☐	☐	
5. *a.* If the choice was yours, would you hire the firm to conduct next year's audit?	☐	☐	☐	
b. If yes, what changes would you make, if any? If no, why would you not rehire the firm?	☐	☐	☐	
6. Are you satisfied with the quality and quantity of information provided by the external auditor relative to the general progress of the audit?	☐	☐	☐	
7. Were identified problems or potential issues brought to your attention in sufficient time to be addressed without delaying or extending the completion of the audit?	☐	☐	☐	

Evaluation of the External Auditors	Yes	No	Not Sure	Comments
Questions for the Organization's Chief Audit Executive				
1. From your perspective in working with the external auditors, are you satisfied with the scope, nature, extent, and timing of testing performed by the external auditors?	☐	☐	☐	
2. Did the external auditors work with you to ensure the coordination of audit efforts to assure the completeness of coverage, reduction of redundant efforts, and the effective use of audit resources?	☐	☐	☐	
3. *a.* Are you satisfied with the knowledge, skills, and abilities of the staff assigned to do the audit work?	☐	☐	☐	
b. Are you satisfied with the engagement leadership assigned, including the partner(s), manager(s) and fieldwork leaders?	☐	☐	☐	
4. *a.* Did the external auditors work with the internal auditors according to the plan?	☐	☐	☐	
b. Was cooperative work conducted in the spirit of professionalism and mutual respect?	☐	☐	☐	
c. Are you satisfied with the quality and quantity of information provided by the external auditor relative to internal audit's performance related to the audit?	☐	☐	☐	
5. Are you satisfied that the external auditor remains independent of the organization in spite of any audit-related, or nonaudit services the auditor provides to the organization?	☐	☐	☐	
6. Are you aware of any other information that might impair the independence of the external audit firm?	☐	☐	☐	
7. *a.* If the choice was yours, would you hire the firm to conduct next year's audit?	☐	☐	☐	
b. If yes, what changes would you make, if any? If no, why would you not rehire the firm?	☐	☐	☐	

(continued)

Evaluation of the External Auditors	Yes	No	Not Sure	Comments
Questions for the Organization's CFO (or Organization's Highest-Level Finance Officer)				
1. From your perspective in working with the external auditors, are you satisfied with the scope, nature, extent, and timing of testing performed by the external auditors?	☐	☐	☐	
2. Are you satisfied with the knowledge, skills, and abilities of the staff assigned to the audit work?	☐	☐	☐	
3. Are you satisfied with the engagement leadership assigned, including the partner(s), manager(s), and fieldwork leaders?	☐	☐	☐	
4. Did the external auditors provide constructive observations, implications, and recommendations in areas needing improvement, particularly with respect to the organization's internal control system over financial reporting?	☐	☐	☐	
5. *a.* If the choice was yours, would you hire the firm to conduct next year's audit?	☐	☐	☐	
b. If yes, what changes would you make, if any? If no, why would you not rehire the firm?	☐	☐	☐	
6. Are you satisfied with the quality and quantity of information provided by the external auditor relative to the general progress of the audit?	☐	☐	☐	
7. Were identified problems or potential issues brought to your attention in sufficient time to be addressed without delaying or extending the completion of the audit?	☐	☐	☐	
Questions for the Organization's Controller (or Organization's Highest-Level Accounting Professional)				
1. From your perspective in working with the external auditors, are you satisfied with the scope, nature, extent, and timing of testing performed by the external auditors?	☐	☐	☐	
2. Are you satisfied with the knowledge, skills, and abilities of the staff assigned to the audit work?	☐	☐	☐	

Evaluation of the External Auditors	Yes	No	Not Sure	Comments
Questions for the Organization's Controller (or Organization's Highest-Level Accounting Professional) (cont.)				
3. Are you satisfied with the engagement leadership assigned, including the partner(s), manager(s), and fieldwork leaders?	☐	☐	☐	
4. *a.* If the choice was yours, would you hire the firm to conduct next year's audit?	☐	☐	☐	
b. If yes, what changes would you make, if any? If no, why would you not rehire the firm?	☐	☐	☐	
5. Are you satisfied with the quality and quantity of information provided by the external auditor relative to the general progress of the audit?	☐	☐	☐	
6. Were identified problems or potential issues brought to your attention in sufficient time to be addressed without delaying or extending the completion of the audit?	☐	☐	☐	
Other Comments, Further Questions				

Single Audits—Office of Management and Budget Circular No. A-133: Audits of States, Local Governments, and Non-Profit Organizations

PURPOSE OF THIS TOOL: The Office of Management and Budget (OMB) Circular A-133 was issued pursuant to the Single Audit Act of 1984 and subsequent amendments. It establishes the standards in order to obtain consistency and uniformity among federal agencies for the audit of states, local governments, and not-for-profit organizations expending federal awards.

This tool is intended to aid not-for-profit organizations in complying the requirements and expectations of the Single Audit Act, as well as to assist with compliance of the provisions of the act.

The Single Audit Act requires that nonfederal entities that expend $500,000 or more in a year in federal awards have a single or program-specific audit in accordance with the provisions of the act's audit requirements. The determination of when an award is expended should be based on when the award activity occurs. Expenditures include cash transactions, loans, loan guarantees, federally restricted endowment funds, and various other types of noncash assistance, such as interest subsidies. A program-specific audit may be elected only when an auditee expends federal awards under one federal program (excluding research and development, which is considered as one major program) and the federal program's laws, regulations, or grant agreements do not require the auditee to have a financial statement audit.

The American Recovery and Reinvestment Act of 2009 (ARRA) provides a new source of federal funds, with a primary purpose of the ARRA to preserve and create jobs to promote economic recovery, provide investments needed to increase economic efficiency, and to assist those most impacted by the recession. The ARRA provides $787 billion of funding with a majority of the funds going towards existing programs, and with a goal of using at least 50 percent of the funds for programs that can be initiated within a limited time frame from its enactment. The ARRA intends to make a short- and long-term impact in investments that create jobs and provide future resources through building infrastructure, promoting science and education, improving health care, and increasing clean energy use.

With respect to the utilization of the ARRA funds, the ARRA holds organizations receiving such fund to a high standard of accountability and transparency. This includes additional federal reporting requirements placed on institutions receiving ARRA funds. The OMB requires organizations to separately track and monitor recovery funds, thereby not allowing organizations to commingle the funds with non-ARRA funds

Additionally, the ARRA requires organizations with such funding to ensure performance of audits and reviews to assure accountability, consistency, controls, and transparency. The ARRA will also place a greater burden on institutions in receipt of ARRA funds to assess how such funds complement their existing research and other organizational strategies, and what level of institutional infrastructure and resources are necessary to manage and monitor expenditures funded through the ARA.

Requirements and Responsibilities

Recipients of federal awards are required to

- maintain a system of internal control over all federal programs in order to demonstrate compliance with pertinent laws and regulations.
- identify all grant programs by Catalog of Federal Domestic Assistance number and title, awarding agency, year of award, and any pass-through entities if applicable.
- ensure that audits mandated under OMB Circular A-133 are performed and filed with appropriate federal entities as required.
- follow-up on any audit findings, questioned costs, or compliance issues. This involves specific responses and, when necessary, taking corrective action that will resolve current or previous findings, or both.
- complete the official data collection and single audit submission form that is prepared in conjunction with the external auditor. The reporting package is submitted electronically, with the data collection form electronically signed by both the auditee and the auditor. The recipient organization is legally responsible for the accuracy and timely submission of these forms even if the auditor prepares the forms.
- if the organization has any subrecipients—for example, organizations that the federal awards are passed on to—additional monitoring procedures must be performed.

Auditors of recipients of federal awards are required to

- plan and conduct the audit in accordance with generally accepted auditing standards (GAAS) and generally accepted government auditing standards (GAGAS).
- determine if the organization-wide and federal awards financial statements are presented fairly in accordance with GAAS and GAGAS.
- determine if Schedule of Expenditures of Federal Awards is presented fairly in relation to the organization's financial statements as a whole.
- perform tests that demonstrate an understanding of the recipient's internal controls in order to support a "low assessed risk" for major programs.
- determine that the recipient has complied with laws, regulations, and grant agreements through review and testing procedures.
- follow-up on the status of previous audit findings.

Awarding agencies have the following responsibilities in the audit process:

- Ensure that audits are completed and filed on time
- Provide technical assistance to auditors and recipients who may have audit questions
- Issue a management decision on financial and compliance audit findings within six months after an audit report has been submitted
- Ensure that recipients follow up on audit findings and develop and implement a corrective action plan if necessary

Reporting

The auditor's report may be in the form of either combined or separate reports. The auditor's report will state that the audit was conducted in accordance with OMB Circular A-133 and include the following:

- An opinion (or disclaimer of opinion) about whether the financial statements and schedules of expenditures are fairly presented in accordance with U.S. generally accepted accounting principles
- Report on the status of internal controls relative to the financial statements and major programs
- Compliance report that describes the degree to which the recipient has complied with laws, regulations, and the terms and conditions of the federal assistance awards
- Schedule of findings and questioned costs
- List of major programs using the required risk-based methodology
- Determination concerning federal programs regarding whether the recipient of the federal award is a "high risk" or "low risk."

Conclusion

The specific requirements and responsibilities of federal agencies and nonfederal recipients are detailed in OMB Circular A-133 (see the circular available at www.whitehouse.gov/omb/circulars/a133/a133.html). Federal agencies are required to apply the provisions of Circular A-133 to all nonfederal entities that receive and expend federal awards either directly from federal awarding agencies or as sub-recipients who receive federal awards from a pass-through entity. Other OMB circulars, including allowable costs and cost allocations, are at this Web site as well.

Peer Review of CPA Firms: An Overview

PURPOSE OF THIS TOOL: This tool is prepared to inform audit committee members about the practice-monitoring programs over the accounting and auditing practices of the substantial majority of CPA firms. This tool is intended to help audit committee members understand the obligations and oversight of CPA firms, and thereby gauge the suitability of the CPA firm for the not-for-profit organization.

Peer review requirements for CPA firms have changed considerably over the years. Currently, most CPA firms undergo a review of their accounting and auditing practice at least once every three years. However, the requirements vary, and not all firms have peer reviews. The audit committee should be aware of when peer reviews are required and what assurance is provided by having a peer review.

Peer Review of a CPA Firm

Peer reviews are required of all CPA firms that are members of the AICPA. However, some CPA firms are not members. Many state boards of accountancy require peer reviews for all licensed CPA firms and sole practitioners who issue reports on financial statements. For not-for-profit organizations subject to the Office of Management and Budget Circular A-133 (Single Audit)—that is, those expending $500,000 or more of federal awards—the auditing firm is required to have a peer review every three years and submit a copy of the peer review report letter to the not-for-profit organization.

A peer review of a CPA firm can be used by an audit committee as a tool to assess whether the CPA firm it hires or is considering hiring

1. has a system of quality control for its accounting and auditing practice that has been designed to meet the requirements of the AICPA's Statements on Quality Control Standards.
2. is complying with that system of quality control during the peer review year to provide the firm with reasonable assurance of complying with professional standards.

The AICPA's standards regarding quality control provide requirements in the areas of auditor independence, integrity, and objectivity; audit personnel management; acceptance and continuance of audit clients and engagements; audit engagement performance; and firm quality control monitoring. Professional standards include generally accepted auditing standards, U.S. generally accepted accounting principles, generally accepted government auditing standards, and the standards on auditor independence.

To conduct its peer review, a CPA firm will engage another CPA firm, a CPA firm group, or a state peer review committee to perform the review. However, in selecting its peer reviewer, the reviewing CPA firm must be independent of the CPA firm being reviewed and must be qualified to perform the review, including matching industry experience. The peer review committee (the body responsible for evaluating and accepting peer reviews) monitors firm independence and approves the peer review team before the peer review taking place.

Types of Peer Reviews

Three different levels of peer reviews exist under the AICPA Peer Review Program:

1. A *system peer review* is an on-site review required for firms performing audits or examinations of prospective financial statements, or both.
2. An *engagement peer review* is performed (off-site) when the CPA firm's highest level of service is a review of financial statements or compilation of financial statements with disclosures.
3. A *report peer review* is performed for firms performing only compilations without disclosures.

Accordingly, for an audit engagement, the audit committee should ascertain that the CPA or firm has had the appropriate system-level peer review.

Peer Review Reports

For system peer reviews, three types of peer review reports exist:

1. An *unmodified report* means that the reviewed firm's system of quality control has been designed to meet the requirements of the quality control standards for an accounting and auditing practice and the system was being complied with during the peer review year to provide the firm with reasonable assurance of conforming with professional standards.
2. A *modified report* means that the design of the firm's system of quality control created a condition in which the firm did not have reasonable assurance of conforming with professional standards in certain instances, or that the firm's degree of compliance with its quality control policies and procedures did provide it with reasonable assurance of conforming with professional standards, except for certain instances.
3. An *adverse report* means that there are significant deficiencies in the design of the firm's system of quality control, pervasive instances of noncompliance with the system as a whole, or both, resulting in material failures to adhere to professional standards on engagements.

Modified reports, and usually unmodified reports, are accompanied by a letter of comments issued by the peer reviewer. A *letter of comments* describes matters that the peer reviewer believes resulted in conditions in which there was more than a remote possibility that the firm would not comply with professional standards and sets forth recommendations regarding those matters. A letter of comments is not prepared when an adverse report is issued because all deficiencies, comments, and recommendations are contained in the report itself.

Peer review requirements specify that the peer review report must identify any specialized industries—for example, the Securities and Exchange Commission, Single Audit, or the Governmental Accounting Standards Board—and the peer review report must specify deficiencies, if any, by industry. In addition, the reviewed firm must submit a representation letter to the peer reviewer.

The reviewed firm is required to respond in writing (called the letter of response) to the peer reviewer's comments on matters in the peer review report or in the letter of comments, or both. The response describes the actions taken or planned with respect to each matter in the report and the letter.

It is recommended that the Not-for-Profit Audit Committee request a copy of the auditor's latest peer review report and letter of comments, if any, and letter of response thereto, and discuss them with the auditor. If a report is modified or adverse, the audit committee should consider the reasons as part of its assessment of whether it should engage or continue to engage the auditor.

Common Misconceptions of Peer Review

1. *Fiction*: A peer review evaluates every engagement audited by a CPA firm. *Fact*: A peer review is performed using a risk-based approach. A peer reviewer must review a sufficient sample of a cross section of engagements to obtain reasonable assurance that the reviewed firm is complying with its quality control policies and procedures. Therefore, it is possible that the review would not disclose all weaknesses in the system of quality control or all instances of lack of compliance with it.
2. *Fiction*: An unmodified report provides assurance with respect to every engagement conducted by the firm. *Fact*: Every engagement conducted by a firm is not included in the scope of a peer review, nor is every aspect of each engagement reviewed. The peer review includes reviewing all key areas of the engagements selected.
3. *Fiction*: If a firm receives a letter of comments, its system of quality control is inadequate. *Fact*: The criterion for including an item in the letter of comments is whether the item resulted in a condition being created in which there was more than a remote possibility that the firm would not comply with professional standards on accounting and auditing engagements. Because this is a very low threshold, most peer reviews result in the issuance of a letter of comments. Peer reviews are considered to be a constructive exercise toward improvement of professional practices.

Questions for the Auditor Regarding Peer Review

The following questions should be asked by the audit committee of its current or prospective auditors to gain a better understanding of the firm's peer review experience.

Question	Yes	No	Comments
1. Is the CPA or firm subject to peer review? If not, please explain.	☐	☐	
2. Has a peer review been performed in the last three years? If not, please explain.	☐	☐	
3. Was a system type of peer review performed?	☐	☐	
4. Did the peer review result in an unmodified report? If not, obtain an explanation of findings and inquire about the status of any follow-up action required by the peer review committee.	☐	☐	
5. Has the firm corrected deficiencies noted in the peer review report or the letter of comments, or both? If not, please explain.	☐	☐	
6. Explain what the comments and recommendations in the letter of comments mean?			
Notes:			
7. Did the peer review committee request any follow-up actions? If so, have these actions been carried out?	☐	☐	
8. Was our organization selected for review during the peer review? (When the firm is the current auditor) If so, were any negative responses noted?	☐	☐	
9. Was the engagement partner (or auditor in charge) selected for review during the peer review? If so, were any negative responses noted on audits performed by them?	☐	☐	
10. Does the firm perform single audits? If so, were they included in the last review? If not, why not?	☐	☐	

Points to Consider When Engaging External Experts and Advisors

PURPOSE OF THIS TOOL: The audit committees of many not-for-profit organizations may deem it necessary to engage external auditors, counsel, or other consultants in the course of carrying out their duties. This tool is intended to assist audit committee members in understanding the process of engaging external experts and advisors, if needed.

When selecting external auditors, counsel, or other consultants (an expert or advisor) for an engagement within the organization, the audit committee should not only consider the education, training, and experience of the specialists and staff assistants actually performing the work, but it should determine that the service provider (1) has a reputation for reliability, integrity, and objectivity; (2) is free of conflicts of interest with respect to the members of the audit committee and the organization; and (3) has the expertise and resources necessary to do the work it is under consideration to do, among other considerations.

The source of funding for payments to the outside advisors should be considered before initiating the process of engaging external resources. Many not-for-profit organizations receive funding support from governmental and other regulated agencies, and funding agreements with these agencies may require the not-for-profit organization to follow statutory or contractual procedures when engaging external resources. Such procedures may include specific procurement requirements for advertising, securing bids, and bid acceptance.

Although the nature of every engagement will be different, the initial steps the audit committee (or its designee) should undertake when engaging external resources include the following:

1. Identify the type of work or service that needs to be done, including the scope.
2. Determine that the expert or advisor has the competence and experience to perform the requested service. Check references with other clients of the service provider.
3. Consider and discuss whether the expert or advisor has a conflict of interest with respect to the not-for-profit organization and members of the audit committee. Such a conflict might arise if the expert or advisor has a relationship with the external auditor, or if they provide service to organizations with similar missions, programs, donors, or other constituent groups. Depending on the nature of the service to be offered, a conflict could arise if the expert or advisor has a relationship with a member of the board of directors or a member of the organization’s management. Be aware of other potential conflicts of interest that may distract the expert or advisor or undermine the work to be done.
4. Determine if the expert or advisor has sufficient resources to perform the work in the time frame specified by the audit committee.
5. Evaluate the scope of work to be performed and other issues, including the proposed plan for payment of fees and expenses.

6. Make sure all parties (including management and the expert or advisor) understand that the audit committee is the owner of the service relationship. Make sure that management understands that the expert or advisor is working on behalf of the audit committee and the audit committee expects management to be fully cooperative and forthcoming with respect to any information that may be requested.
7. Determine the criteria that will be used to measure the expert's or advisor's work and document those criteria in an agreement with the service provider. As with any relationship, communication and managing expectations is important.
8. Evaluate the quality of the work submitted and the performance of the external expert or advisor. See the tool "Evaluating the External Auditors: Questions to Consider" for guidance.

Appendix A: Resources for Audit Committees

PURPOSE OF THIS APPENDIX: Audit committees can take advantage of the Internet and find a wealth of resources to assist them in discharging their responsibilities. This tool provides an overview of organizations and Web sites that contain topical resources for audit committee members to investigate.

The following is a sampling of organizations and Web sites that can assist audit committee members in learning more about their roles, responsibilities, and functions. Some of the organizations listed require membership to access the information. Many public accounting firms and state CPA societies provide information on these subjects as well. As always, monitor your state's not-for-profit laws for audit committee requirements. For example, California passed the Nonprofit Integrity Act of 2004 and requires an audit committee separate from the finance committee.

Alliance for Nonprofit Management www.allianceonline.org

The Alliance for Nonprofit Management is a coalition of not-for-profit technical assistance providers, not-for-profit umbrella organizations, funders, public regulators, professional services providers, academics, and others that share an interest in promoting good governance for not-for-profit organizations.

AICPA www.aicpa.org

The AICPA is the national professional association for all CPAs. This includes CPAs working as independent auditors, accountants, or consultants in public practice, business and industry (CFOs, controllers, internal auditors, and others), government, not-for-profit organizations, and the academic community.

The AICPA has developed this Audit Committee Toolkit to aid audit committee members in performing their functions. In addition, the AICPA produces publications on accounting and auditing, financial reporting, tax, technology, and many other relevant topics. Some additional online resources useful to audit committees include the following:

- Audit Committee Effectiveness Center—www.aicpa.org/acec
- Antifraud and Corporate Responsibility Resource Center—www.aicpa.org/antifraud
- Sarbanes-Oxley Implementation Central—www.aicpa.org/sarbanes/index.asp

American Institute of Philanthropy www.charitywatch.org

This site provides access to the American Institute of Philanthropy's *Charity Watchdog Report*, including the criteria used to evaluate charities listed in the report.

American Society of Association Executives www.asaenet.org

The American Society of Association Executives is a national organization serving the needs of association professionals through its education and certification programs, publications, research and information, public policy and public relations activities, and member services.

Association of Audit Committee Members, Inc. www.aacmi.org

The Association of Audit Committee Members is a not-for-profit association of audit committee members dedicated to strengthening the audit committee by developing national best practices. They are devoted exclusively to improving audit committee oversight.

Association of Certified Fraud Examiners www.cfenet.com

The Association of Certified Fraud Examiners is a global professional organization dedicated to fighting fraud and white collar crime. With chapters around the globe, the association is networked to respond to the needs of anti-fraud professionals everywhere. It offers guidance on fraud prevention, detection, and investigation, as well as internal controls.

Association of Community College Trustees www.acct.org

The Association of Community College Trustees is a not-for-profit educational organization of governing boards, representing more than 6,500 elected and appointed trustees who govern over 1,200 community, technical, and junior colleges in the United States, Canada, and England.

Association of Governing Boards of Colleges and Universities www.agb.org

The Association of Governing Boards of Universities and Colleges is a national organization providing university and college presidents, board chairs, and individual trustees of both public and private institutions with the resources they need to enhance their effectiveness.

BoardSource www.boardsource.org

BoardSource is a resource for practical information, tools and best practices, training, and leadership development for board members of not-for-profit organizations worldwide. Through its programs and services, BoardSource enables organizations to fulfill its missions by helping build strong and effective not-for-profit boards.

BBB Wise Giving Alliance www.bb.org/charity-reports/

The Better Business Bureau provides a “charity watchdog” service for donors called the Wise Giving Alliance. This site provides instructions on how to enroll in the program and how to access the evaluation reports.

California Attorney General http://ag.ca.gov/charities.php

Whether doing business in the state of California or not, not-for-profit organizations will find resources regarding governance on this site.

Charity Navigator www.charitynavigator.org

This is a charity watchdog service providing evaluation of charities for donors.

Committee of Sponsoring Organizations of the Treadway Commission www.coso.org

The Committee of Sponsoring Organizations of the Treadway Commission (COSO) is a voluntary private sector organization dedicated to improving the quality of financial reporting through business ethics, effective internal controls, and corporate governance. Originally formed in 1985 to sponsor the National Commission on Fraudulent Financial Reporting, COSO has released the following publications:

Internal Control

Guidance on Monitoring Internal Control Systems (2009)
Internal Control over Financial Reporting—Guidance for Smaller Public Companies (2006)
Guidance on Monitoring Internal Control Systems Internal Control Issues in Derivatives Usage (1996)
Internal Control—Integrated Framework (1992)

Enterprise Risk Management

Enterprise Risk Management—Integrated Framework (2004)
Effective Enterprise Risk Oversight: The Role of the Board of Directors (2009)
Strengthening Enterprise Risk Management for Strategic Advantage (2009)

Conference Board www.conference-board.com

The Conference Board is a global, independent membership organization that creates and disseminates knowledge about management and the marketplace to help businesses strengthen their performance and better serve society. It conducts research, convenes conferences, makes forecasts, assesses trends, publishes information and analysis, and brings executives together to learn from one another.

Council on Foundations www.cof.org

The Council on Foundations is a membership organization of more than 2,000 grantmaking foundations and giving programs worldwide. It provides leadership expertise, legal services, and networking opportunities.

Ethics Officers Association www.theecoa.org

The Ethics Officers Association (EOA) is the professional association exclusively for managers of ethics, compliance, and business conduct programs. The EOA provides ethics officers with training and a variety of conferences and meetings for exchanging best practices in a frank, candid manner.

Ethics Resources Center www.ethics.org

The Ethics Resource Center is a not-for-profit, nonpartisan educational organization whose vision is a world where individuals and organizations act with integrity. Its mission is to strengthen ethical leadership worldwide by providing leading edge expertise and services through research, education, and partnerships. Especially useful are its resources on business and organizational ethics.

Financial Executives International www.fei.org

The Financial Executives International is the professional association for senior level financial executives, including CFOs, vice presidents of finance, controllers, treasurers, and tax executives. It provides peer networking opportunities, emerging issues alerts, personal and professional development, and advocacy services.

Financial Accounting Standards Board www.fasb.org

Since 1973, the Financial Accounting Standards Board has been the designated organization in the private sector for establishing standards of financial accounting. This site provides access to multiple resources including the *Accounting Standards Codification*, a compilation of all U.S. generally accepted accounting principles literature in a searchable, codified database.

Governance Check Sheet—Department of the Treasury—IRS
www.irs.gov/pub/irs-tege/governance_check_sheet.pdf

A check sheet that is used by exempt organizations revenue agents in the examination of Internal Revenue Code Section 501(c)(3) public charities.

GuideStar www.guidestar.org

GuideStar provides access to information on a wide variety of not-for-profit organizations, including their IRS Form 990.

Harvard Business School's Corporate Governance, Leadership & Values www.cglv.hbs.edu

Harvard Business School's Corporate Governance, Leadership & Values Web site is a comprehensive overview of research, educational programs, and other activities at Harvard Business School aimed at providing new frameworks for thought and practice in the interrelated areas of corporate governance, leadership, and values. It includes links to the ongoing workshop series; background papers; research programs, such the Corporate Governance Initiative; executive education programs; viewpoints on key issues published in the national press; faculty comments in the media; and an online forum for exchanging views on emerging issues.

Independent Sector www.independentsector.org

The Independent Sector is committed to strengthening, empowering, and partnering with not-for-profit and philanthropic organizations in their work on behalf of the public good.

Institute of Internal Auditors www.theiia.org

The Institute of Internal Auditors (IIA) is an international organization that meets the needs of a worldwide body of internal auditors. IIA focuses on issues in internal auditing, governance, and internal control, IT audit, education, and security worldwide. The institute provides internal audit practitioners, executive management, boards of directors, and audit committees with standards, guidance, best practices, training, research, and technological guidance for the profession.

Institute of Management Accountants www.imanet.org

The Institute of Management Accountants (IMA) is a professional organization devoted to management accounting and financial management. The IMA influences the concepts and ethical practices in management accounting and financial management. Its ethical standards provide guidance to practitioners for maintaining the highest levels of ethical conduct.

IRS www.irs.ustreas.gov/charities/index.html

The IRS has tax information for charities and other not-for-profit organizations.

IT Governance Institute www.itgi.org

Established by the Information Systems Audit and Control Association and Foundation in 1998, the IT Governance Institute (ITGI) exists to assist enterprise leaders in understanding and guiding the role of IT in their organizations. ITGI helps senior executives to ensure that IT goals align with those of the business, deliver value, and perform efficiently, while IT resources are properly allocated and its risks mitigated.

Through original research, symposia, and electronic resources, ITGI helps ensure that boards and executive management have the tools and information they need to effectively manage the IT function.

National Association of College and University Business Officers www.nacubo.org

The National Association of College and University Business Officers represents chief administrative and financial officers through a collaboration of knowledge and professional development, advocacy, and community. Its vision is to define excellence in higher education business and financial management.

National Association of Corporate Directors www.nacdonline.org

Founded in 1977, the National Association of Corporate Directors (NACD) is an educational, publishing, and consulting organization in board leadership and the only membership association for boards, directors, director-candidates, and board advisors. The NACD promotes high professional board standards, creates forums for peer interaction, enhances director effectiveness, asserts the policy interests of directors, conducts research, and educates boards and directors concerning traditional and cutting-edge issues.

National Council of Nonprofits www.councilofnonprofits .org

The National Council of Nonprofit Associations seeks to guarantee that all not-for-profits have access to knowledge and resources through the national network of state associations and that the not-for-profit sector retains a vibrant and strong voice at the national and state level that speaks to its issues and those of their constituencies.

Nonprofit Coordinating Committee of New York, Inc. www.npccny.org

The Nonprofit Coordinating Committee of New York, Inc. was established to help not-for-profits meet common challenges and problems, to serve as a meeting ground, and to strengthen the not-for-profit sector as a whole.

Nonprofit Financial Center www.nfconline.org

The Nonprofit Financial Center is a not-for-profit organization dedicated to helping not-for-profits grow and prosper through practical financial management.

The Non-Profit Resource Center www.1800.com/nprc/index.html

This site provides access to not-for-profit-specific accounting standards, Office of Management and Budget circulars and compliance supplements, the Catalog of Federal Domestic Assistance, and other resources.

Nonprofit Risk Management Center www.nonprofitrisk.com

The Nonprofit Risk Management Center is a not-for-profit organization offering services such as technical assistance, software, training, and consulting help on an array of risk management topics.

Office of Management and Budget Circular A-133
www.whitehouse.gov/omb/rewrite/circulars/a133/a133.html

The Office of Management and Budget publishes the Circular A-133 federal regulations related to audits of not-for-profit organizations that receive and expend federal funds.

Public Company Accounting Oversight Board www.pcaobus.org

The Public Company Accounting Oversight Board is a private sector, not-for-profit corporation, created by the Sarbanes-Oxley Act of 2002, to oversee the auditors of public companies in order to protect the interests of investors and further the public interest in the preparation of informative, fair, and independent audit reports.

The Sarbanes-Oxley Act of 2002 www.aicpa.org/info/sarbanes_oxley_summary.htm

The Sarbanes-Oxley Act regulates the accounting profession and public companies. Although the provisions of Section 301 for a public company audit committee do not apply to the not-for-profit sector, they can be viewed as a best practice.

Appendix B: Analytical Procedures for Not-for-Profit Organizations

The following four analytical procedures are from the course *Analytical Procedures for Nonprofit Organizations* (product no. 730226). For more information on this course, please go to www.cpa2biz.com

The Defensive Interval Ratio

The Defensive Interval Ratio (DI) measures the adequacy of the resources of the not-for-profit to support the mission. The formula is

$$\frac{\text{Cash + Marketable Securities + Receivables}}{\text{Average Monthly Expenses}}$$

The result is the number of months' expenses that the organization can cover if there are no additional inflows of quick current assets. The ratio measures liquidity and is similar to the current ratio sometimes used by for-profit businesses. The primary difference is that the defensive interval measures the liquidity in terms of time; in other words, number of months as opposed to the excess of the current assets over the current liabilities. The author feels that this is the quality that makes the ratio more meaningful than the standard current ration.

The ratio is a conservative one that is most appropriate where inflows are variable. Therefore, it would seem to be applicable for charities that are dependent upon contributions from the general public.

Liquid Funds Indicator

Another Greenlee-Bukovinsky identified relations, the liquid funds indicator, measures how many months the organization has before it completely consumes its liquid assets, assuming that no additional revenues flow into the organization. This one is more conservative than the DI because it excludes those marketable securities upon which the not-for-profit organization depends for current income.

$$\frac{\text{Net Assets} - \text{Restricted Endowment-Fixed Assets} - \text{Prepaid Expenses}}{\text{Average Monthly Expenses}}$$

Using average monthly expenses as a denominator, this approach, like that of the DI, produces a result in terms of a time period.

Net Temporarily Restricted Asset Ratio

Previously called the deferred revenue ration, but renamed as a result of the virtual elimination of deferred revenue in most not-for-profit organizations, this ratio indicates if the not-for-profit organization is borrowing from the future, or from net assets intended to be used in future periods.

Contribution revenue is no longer deferred to future periods just because the donor specified his, her, or its (in the case of a corporation or other legal entity) gift to be used for some purpose that is dependent upon the passage of time.

Rather, contributions are income in the accounting period in which there is evidence of a promise to give and the promise of the gift is not conditional.

The formula for this operating ratio is

$$\frac{\text{Temporarily Restricted Net Assets + Deferred Revenue}}{\text{Cash + Cash Equivalents}}$$

Deferred revenue can occur in the case of exchange-type revenue when the not-for-profit organization receives payments in one accounting period but does not earn the income until it performs certain services in a future period, such as

- in the case of grant proceeds received in advance of the conditions of the grant having been met by the organization.
- in the case of membership dues received in the fiscal period prior to the period to which the dues apply.

Disaggregated Revenue Dependency Ratios

Although no industry averages were located for just grant dependency or general contribution dependency, some may be available from peer group organizations that serve a particular charity. Most such organizations are believed to record grants separately from other voluntary contributions so the accumulation of such disaggregated data should not be difficult.

Two additional ratios that would be of value to organizations that have a significant amount of both grant and contribution revenue and are subsets of the contributions and grants ratio are

Voluntary Contributions Ratio (CGc) $\quad \dfrac{\text{Voluntary Contributions}}{\text{Total Revenue}}$

Grants Ratio (CGg) $\quad \dfrac{\text{Grants}}{\text{Total Revenue}}$

Appendix C: Sample Not-for-Profit Audit Committee Charter

PURPOSE OF THIS TOOL: This tool contains sample language that may be used by an organization in developing an audit committee charter. As such, the audit committee matrix should be used to develop the audit committee charter and should be customized for the specific not-for-profit organization.

Purpose

The audit committee oversees proper external review of the not-for-profit audited financial statements, as well as the organization's risk management to include monitoring the internal control environment. Each member shall be free of any relationship that, in the opinion of the board, would interfere with his or her individual exercise of independent judgment.

Reporting

The audit committee reports directly to the not-for-profit organization'sboard of directors (board).

Responsibilities

Specifically, the audit committee performs the following functions:

- Develops and periodically reviews audit-related policies; has a regular process of determining whether it is receiving quality audit services for a fair price based on established policies and regulations;
- Meets with the audit firm to review the audited financial statements;
- Addresses any issues identified in the required communications and management letter;
- Solicits from the audit firm observations on staff skills, qualifications, and performance related to those audited functions;
- Reviews the performance of the auditors, ensuring continued independence;
- Reviews the audit plans for the coming year and discusses with the external audit firm and internal auditor(s);
- Reviews with management, internal audit, and the external auditor, the internal control process and risk management and mitigation process;
- Reports and recommends the results of audit findings to board for approval;
- Acts as external point of contact for any whistle-blowing issues, and, if necessary, initiates special investigations of policies, procedures, and practices;
- Reviews the IRS Form 990 annually, prior to submission;
- Reviews the presentation of the financial information in the annual report before printed; and
- Conducts private executive sessions at least annually with the external auditors, person conducting the internal audit function, and management.

Composition

- The committee consists of three to five persons, a majority of whom must be board members.
- The committee must include members with basic expertise in financial management; thecommittee may wish to consult with an independent financial expert on special topics.
- Members of the finance and investment committee may not serve on this committee.
- The not-for-profit organization's CEO and CFO do not serve on the audit committee because they are not independent.

Terms

- The members of this committee are selected by the board chair in consultation with the president and CEO and the audit committee chair, and are approved by the board.
- All committee members, excluding the person serving as chair, may serve two three-year terms.

Meetings

The audit committee meets as needed to fulfill its responsibilities, but will meet at least twice annually: once to review the audit plan and once to review the audited financial statements and the IRS Form 990 and related documents, and approve the audit engagement and special investigations related to fraud, financial irregularities, and internal control failures.

Approved by the not for profit organization's board of directors ________________________ on ________